BofA SECURITIES

US Banks: Reading the Tea Leaves

Peak rates solve a lot (not all) of problems

Industry Overview

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Equity
United States
Banks

Ebrahim H. Poonawala
Research Analyst
BofAS
+1 646 743 0490
ebrahim.poonawala@bofa.com

Brandon Berman
Research Analyst
BofAS
+1 646 855 3933
brandon.berman@bofa.com

Gabriel Angelini
Research Analyst
BofAS
+1 646 855 3081
gabriel.angelini@bofa.com

Isiah Austin
Research Analyst
BofAS
+1 646 855 0472
isiah.austin@bofa.com

David Kigunda
Research Analyst
BofAS
+1 646 743 0179
david.kigunda@bofa.com

Peak rates could serve as mini clearing event

While we are careful to not getting carried away, peak interest rates do have potential to serve as a mini clearing event for bank stocks. Most pressure points this cycle – margin squeeze due to rising deposit costs, TBV hit due to MTM losses on bonds, CRE re-pricing, credit losses due to hard landing – stem from risks due to higher for longer interest rates. Lower rates = reduced likelihood of tail risk events = higher valuation multiples for bank stocks that are trading near 80yr lows vs. S&P Exhibit 1.

History doesn't repeat, but often rhymes: revisiting 1995

Banks stocks rose 54% in 1995 (+34% S&P) on the back of a Fed pause following 250bp in rate hikes. While we recognize that no two periods are the same, the combination of discounted valuations and investor comfort around 2024 EPS (consensus -25% YTD) could lead to another bear market bounce (seven and counting since Fed began hiking Exhibits 2-4). Best case, peak rates could mark near term bottom in bank stocks vs. S&P.

NII pressures easing, but QT could play spoilsport

2022 the year of asset repricing (+ve for margins), 2023 the year of deposits repricing (-ve for margins), 2024 could be a grind given the potential for asset yields to mitigate deposit repricing risk Exhibit 5. Messaging from bank mgmt. teams suggests moderating margin pressures, but $100bn/month in QT could play spoilsport. Not unrealistic that certain banks could see QoQ NII growth next year, especially if loan demand re-emerges.

TBV growth, dividend yields factors once again

TBV growth should accelerate in a declining rate backdrop (reversal of unrealized bond losses), thereby improving valuation optics with stocks trading at 1.5x stated TBV vs 1.1x adjusted for MTM bond losses (AOCI). Dividend yields 5-6% have been easy to ignore with a risk-free rate of 5%+, but should become a factor if markets believe that rates headed lower. BofA Economics/Rates team forecast: 10yr UST yielding 3.5% by YE24; first Fed rate-cut 2Q24 Exhibits 6-7.

Things could always go south

A resurgence in inflation (= significantly higher interest rates) has the potential to more than reverse any stock bounce. Plus, credit cycle on the come (only the severity is up for debate) as the lagged effects of higher rates catch-up with businesses/consumers. Our base case view remains that a credit cycle is likely to be closer to the early 2000s (earnings event) vs 2008/09 (capital event). Our forecast assumes net charge offs nearly doubling to 40bp in 2024 vs 23bp in 2023 on avg.; credit provisioning costs +20% YoY.

Pick your spots and add exposure

We believe investors should selectively add exposure, especially if two conditions hold, peak interest rates behind and no 2024 US recession (= BofA Global Research macro view). Stocks we highlight: Wells Fargo, US Bancorp, Goldman Sachs, Morgan Stanley, Fifth Third, Keycorp, BNY Mellon, Northern Trust, Western Alliance, East West.

Relevant research

US Banks: Earnings & beyond: Bleak
29 October 2023

Acronym

CRE: commercial real estate

QT: quantitative tightening

NII: net interest income

Peak rates = a clearing event

Per BofA strategy team: "long leverage; REITs, banks, retail, utilities, small cap, Europe, China + distressed tech best upside." Relevant research: Long Long-End = Long Leverage

Exhibit 1: US banks at 80-year low vs S&P 500
Banks vs S&P 500 (price relative)

Source: BofA Global Investment Strategy, Bloomberg.

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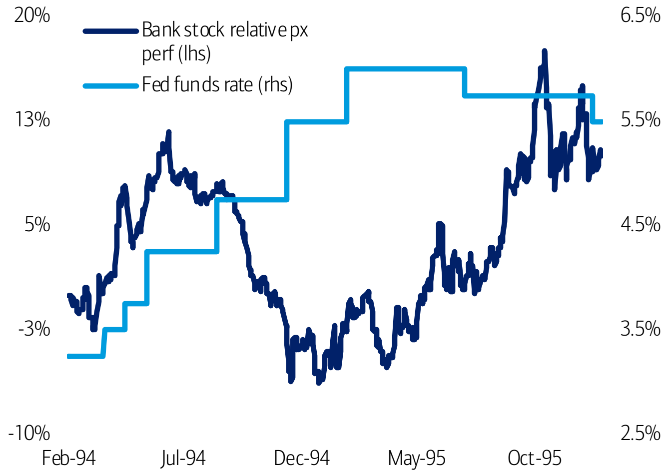
Revisiting 1994/1995: We revisited the last time the Fed had to tighten aggressively...what happened? Fed Funds rate from 3% to 5.5% starting 1994. GDP growth 4% to 2.7% in 1995. What did bank stocks do? After underperforming the S&P by ~700bp in 1994 (Bank index was -9% for the year), banks outperformed in 1995, rising 54% vs. +34% S&P.

Exhibit 2: Bank stocks rebounded sharply in '95 after u/p in '94...
Bank stock px perf. vs fed funds rate



Source: BofA Global Research, Bloomberg

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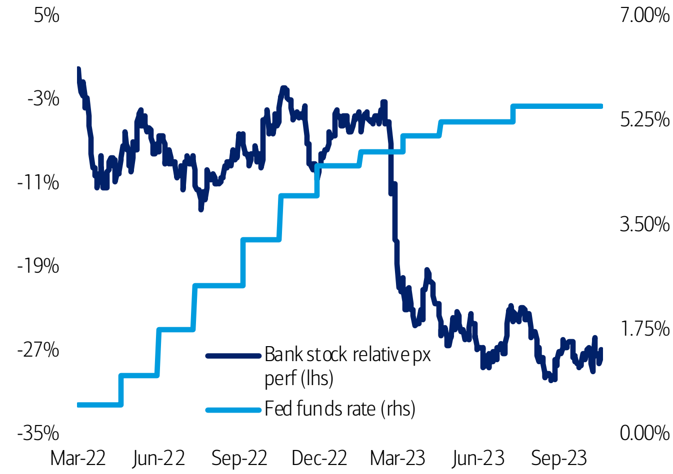
Exhibit 3: ...but have yet to see a rebound this cycle
Bank stock px perf. vs fed funds rate



Source: BofA Global Research, Bloomberg

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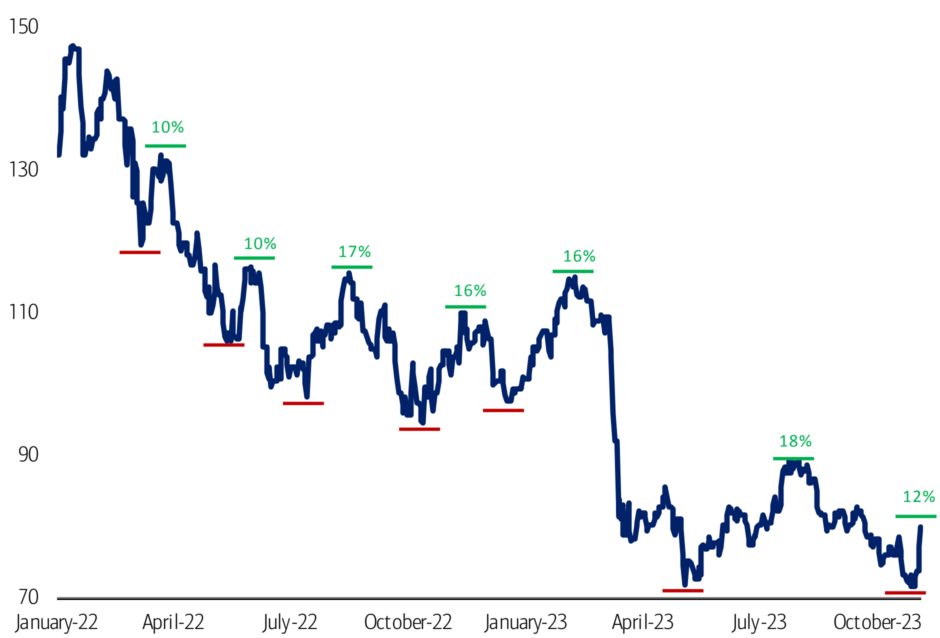
> At the very least peak rates could lead to another bear market bounce...best-case, could mark a cyclical bottom in bank stocks relative to the S&P.

Exhibit 4: There have been seven bear-market rallies since March 2022
Bear market rallies since the beginning of 2022



Source: BofA Global Research, Bloomberg

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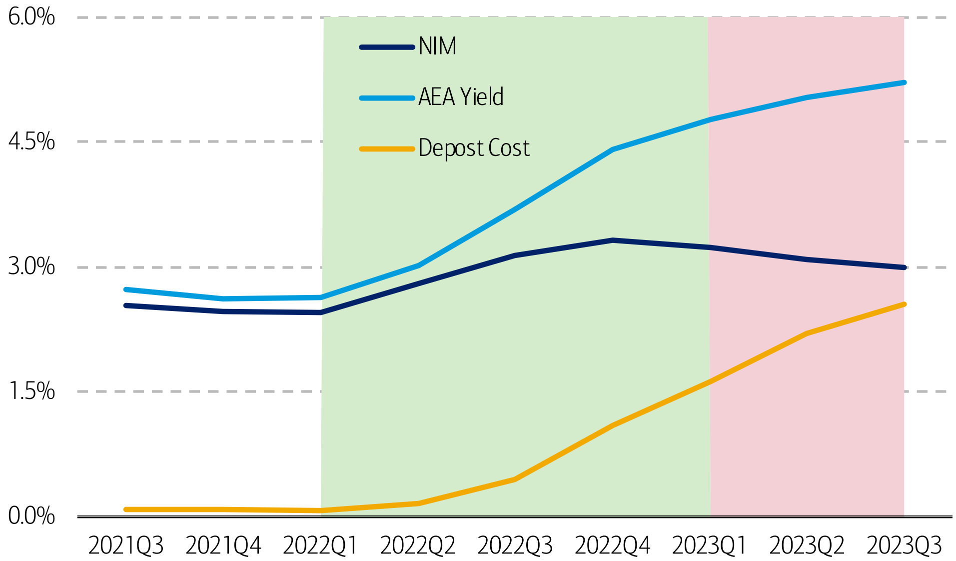
Been a rough journey, but structurally higher interest rates (vs. a decade of zero bound rates) a net positive for the banking industry. Net interest margin pressures could ease in 2024 YoY given the combination of moderating deposit repricing pressures (assuming peak rates behind) and repricing asset yields.

2022 the year of asset repricing (+ve for margins), 2023 the year of deposits repricing (-ve for margins), 2024 could be a grind given the potential for repricing asset yields to offset some/all of funding cost pressures

Exhibit 5: NIM has declined as growth in deposit costs has outpaced AEA yield expansion
NIM, AEA yield, Deposit cost, 3Q21 to 3Q23.



Source: BofA Global Research, SNL Financial

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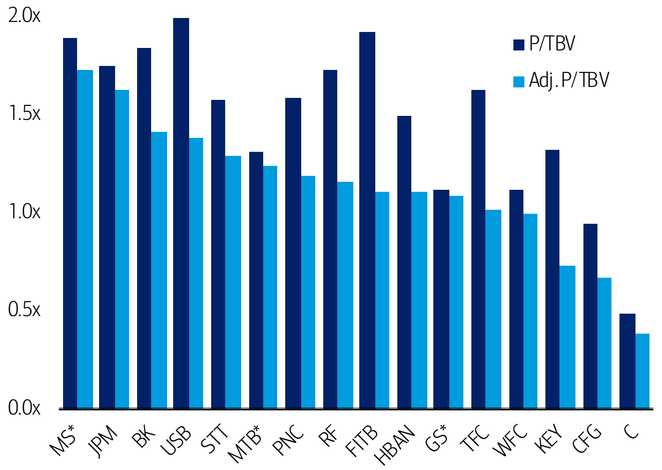
Lower rates = lower unrealized losses on bond books = boost to TBV = fading capital concerns.

Exhibit 6: Pull-to-par on bond books to boost TBV growth…
Large-cap banks P/TBV vs P/TBV ad. for AOCI



Source: BofA Global Research, SNL Financial, company filings. Note: MS, MTB, GS AOCI as of 2Q23.

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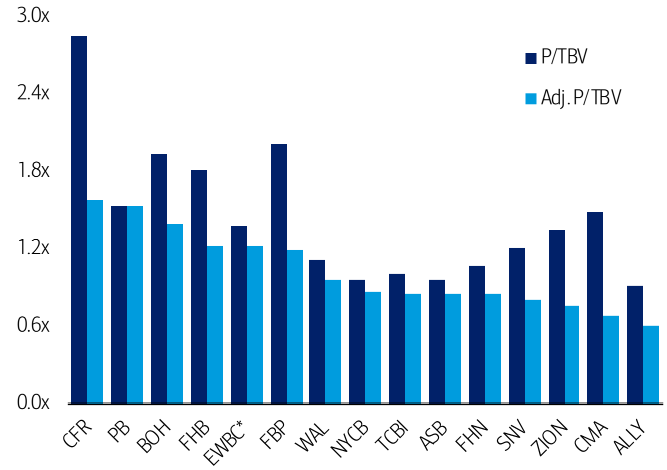
Exhibit 7: …accelerate if rates continue to move lower
Mid-cap banks P/TBV vs P/TBV adj for AOCI



Source: BofA Global Research, SNL Financial, company filings. Note: EWBC AOCI as of 2Q23.

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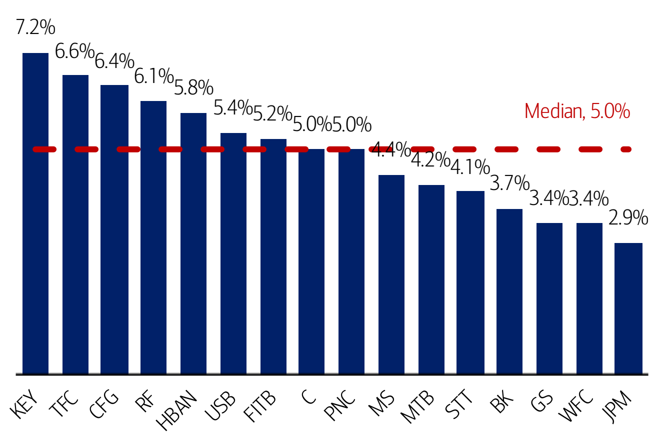
Dividend yields could re-emerge as a factor if Street expectations for lower rates / Fed rate cuts firm-up over the coming months. BofA Economics/Rates team forecast: 10yr UST yielding 3.5% by YE24; first Fed rate-cut 2Q24.

Exhibit 8: Large cap banks avg. dividend yield is 5.0%
Current dividend yield



Source: BofA Global Research, SNL Financial

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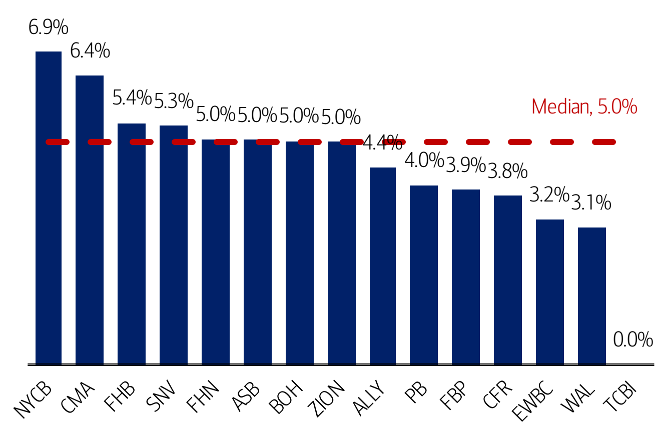
Exhibit 9: Mid cap banks avg. dividend yield is 5.0%
Current dividend yield



Source: BofA Global Research, SNL Financial

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Stocks mentioned

Prices and ratings for stocks mentioned in this report

BofA Ticker	Bloomberg ticker	Company name	Price	Rating
BK	BK US	BNY Mellon	US$ 45.25	B-1-7
EWBC	EWBC US	East-West	US$ 59.11	B-1-7
FITB	FITB US	Fifth Third Bank	US$ 26.46	B-1-7
GS	GS US	Goldman Sachs	US$ 327.62	B-1-7
KEY	KEY US	KeyCorp	US$ 11.39	C-1-8
MS	MS US	Morgan Stanley	US$ 76.26	B-1-7
NTRS	NTRS US	Northern Trust	US$ 71.35	B-1-7
USB	USB US	U.S. Bancorp	US$ 35.49	B-1-7
WFC	WFC US	Wells Fargo	US$ 41.62	B-1-7
WAL	WAL US	Western Alliance	US$ 48.27	C-1-7

Price objective basis & risk

East West Bancorp, Incorporated (EWBC)

Our $74 PO is based on 50%/50% weighting between our 2024e EPS and 2024e TBV. We assign 9.5x/1.5x multiples respectively, below the bank's 5 year pre pandemic median of 14.3x/2.4x given heightened uncertainty surrounding EPS/ROTCE outlooks, owing to the macro backdrop.

Downside risks to our PO are: worse than expected credit losses, greater than expected net interest margin compression, and slower than expected economic growth. Upside risks to our PO are: credit resilience, better than expected margin performance, and stronger than expected economic growth.

Fifth Third Bank (FITB)

Our $33 PO is based on a 50%/50% weighting between our 2024e EPS and 2024e TBV. We assign 11.0x/2.0x multiples, respectively, above the bank's 5 year pre pandemic median of 9.4x/1.2x given favorable EPS/ROTCE outlooks. Downside risks to our PO: slower-than-guided loan growth on weaker economic activity, and/or a deterioration in credit quality. Upside risks to our PO are a better-than-expected improvement in the macro environment, stronger-than-anticipated balance sheet growth, and/or better expense management.

Goldman Sachs (GS)

Our $388 PO is based on a 50%/50% weighting between our 2024e EPS and 2024e TBV. We assign 12x/1.4x multiples, respectively, above the bank's 5 year pre pandemic median of 10.6x/1.2x given lower credit risk into a potential recession. Downside risks to our PO: weaker economy/capital markets, macro or geo-political issues, competition, structural pressures, tougher global regulation, and litigation. Upside risks: stronger capital markets activity.

KeyCorp (KEY)

Our $12 PO is based on a 50%/50% weighting between our 2024e EPS and 2024e TBV. We assign 8.5x/1.3x multiples, respectively, below the bank's 5 year pre pandemic median of 11.9x/1.4x given heightened uncertainty surrounding EPS/ROTCE outlooks, owing to the macro backdrop. Downside risks to our PO: higher for longer interest rate environment increasing deposit costs, greater than expected expenses, inability to maximize balance sheet efficiency, and the announcement of expensive deals. Upside risks: lower than expected credit losses and better than expected PPNR growth.

Morgan Stanley (MS)

Our $90 PO is based on 50%/50% weighting between our 2024e EPS and 2024e TBV. We assign 17.0x/1.8x multiples respectively, above the bank's 5 year pre pandemic median of 11.7x/1.3x given an improved (stickier) revenue mix driven by its wealth and asset management segments.

Risks to the upside is stronger wealth/asset management trends and capital markets activity and higher rates. Risks to the downside are a weak economy/capital markets, increased macro issues, tougher regulation, and litigation.

Northern Trust Corporation (NTRS)

Our $85 PO is based on 50%/50% weighting between our 2024e EPS and 2024e TBV. We assign 15.5x/1.5x multiples respectively, below the bank's 5 year pre pandemic median of 16.9x/2.3x given heightened uncertainty surrounding EPS/ROTCE outlooks, owing to uncertainty surrounding the outlook for interest rates and equity/bond prices.

Risks to the downside are a selloff in equity/bond markets that would put downward pressure on fee growth, rising deposit costs that would put downward pressure on net interest income, management's inability to execute on efficiency/profitability goals. Risk to the upside driven stronger equity/bond markets, sooner than expected achievement of mgmt's profitability/strategic targets.

The Bank of New York Mellon Corporation (BK)

Our $53 PO is based on 50%/50% weighting between our 2024e EPS and 2024e TBV. We assign 11.0x/1.7x multiples respectively, below the bank's 5 year pre pandemic median of 13.4x/3.1x given heightened uncertainty surrounding EPS/ROTCE outlooks, owing to uncertainty surrounding the outlook for interest rates and equity/bond prices.

Risk to the upside is stronger equity/bond markets. Risks to the downside are a severe selloff in equity/bond markets that that could put downward pressure on fee growth and M&A that could temper capital return.

U.S. Bancorp (USB)

Our $40 PO is based on 50%/50% weighting between our 2024e EPS and 2024e TBV. We assign 10.0x/1.9x multiples respectively, below the bank's 5 year pre pandemic median of 13.3x/2.5x given heightened uncertainty surrounding EPS/ROTCE outlooks, owing to the macro backdrop.

Downside risks to our PO: higher than expected credit losses, greater than expected revenue pressure, regulatory changes that would impact growth/profitability, not fully realizing synergies expected with the acquisition of Union Bank.

Wells Fargo & Company (WFC)

Our $50 PO is based on a 50%/50% weighting between our 2024e EPS and 2024e TBV. We assign 11.5x/1.2x multiples, respectively, below the bank's 5 year pre pandemic median of 12.4x/1.8x given heightened uncertainty surrounding EPS/ROTCE outlooks, owing to the macro backdrop.

Downside risks to our PO: worse-than-expected economic downturn that leads to significantly higher-than-expected credit losses, elevated expense trajectory, slower-than-expected resolution of its consent orders. Upside risks: better-than-expected credit quality (i.e., lower loan losses) and material expense management that improve visibility on future earnings.

Western Alliance Bancorp (WAL)

Our $60 PO is based on 50%/50% weighting between our 2024e EPS and 2024e TBV. We assign 7.0x/1.3x multiples respectively, below the bank's 5 year pre pandemic median of 14.8x/2.8x given heightened uncertainty surrounding EPS/ROTCE outlooks, owing to the macro backdrop.

Downside risks to our PO are: worse than expected credit losses, greater than expected net interest margin compression, and slower than expected economic growth. Upside risks to our PO are: credit resilience, better than expected margin performance, and stronger than expected economic growth.

Analyst Certification

I, Ebrahim H. Poonawala, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

North America - Banks Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
	Citigroup Inc.	C	C US	Ebrahim H. Poonawala
	Cullen/Frost Bankers Inc	CFR	CFR US	Ebrahim H. Poonawala
	East West Bancorp, Incorporated	EWBC	EWBC US	Ebrahim H. Poonawala
	Fifth Third Bank	FITB	FITB US	Ebrahim H. Poonawala
	First Bancorp Puerto Rico	FBP	FBP US	Brandon Berman
	First Horizon Corporation	FHN	FHN US	Ebrahim H. Poonawala
	Goldman Sachs	GS	GS US	Ebrahim H. Poonawala
	JPMorgan Chase & Co.	JPM	JPM US	Ebrahim H. Poonawala
	KeyCorp	KEY	KEY US	Ebrahim H. Poonawala
	M&T Bank	MTB	MTB US	Ebrahim H. Poonawala
	Morgan Stanley	MS	MS US	Ebrahim H. Poonawala
	New York Community Bancorp	NYCB	NYCB US	Ebrahim H. Poonawala
	Northern Trust Corporation	NTRS	NTRS US	Ebrahim H. Poonawala
	Synovus Financial Corp.	SNV	SNV US	Ebrahim H. Poonawala
	The Bank of New York Mellon Corporation	BK	BK US	Ebrahim H. Poonawala
	Toronto-Dominion Bank	TD	TD US	Ebrahim H. Poonawala
	Toronto-Dominion Bank	YTD	TD CN	Ebrahim H. Poonawala
	U.S. Bancorp	USB	USB US	Ebrahim H. Poonawala
	Wells Fargo & Company	WFC	WFC US	Ebrahim H. Poonawala
	Western Alliance Bancorp	WAL	WAL US	Ebrahim H. Poonawala
NEUTRAL				
	Ally Financial	ALLY	ALLY US	Brandon Berman
	Associated Banc-Corp	ASB	ASB US	Brandon Berman
	Bank of Montreal	BMO	BMO US	Ebrahim H. Poonawala
	Bank of Montreal	YBMO	BMO CN	Ebrahim H. Poonawala
	Bank of Nova Scotia	YBNS	BNS CN	Ebrahim H. Poonawala
	Bank of Nova Scotia	BNS	BNS US	Ebrahim H. Poonawala
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	Comerica Incorporated	CMA	CMA US	Ebrahim H. Poonawala
	Huntington Bancshares Inc.	HBAN	HBAN US	Ebrahim H. Poonawala
	Popular Inc	BPOP	BPOP US	Brandon Berman
	Regions Financial	RF	RF US	Ebrahim H. Poonawala
	Royal Bank of Canada	RY	RY US	Ebrahim H. Poonawala
	Royal Bank of Canada	YRY	RY CN	Ebrahim H. Poonawala
	State Street Corporation	STT	STT US	Ebrahim H. Poonawala
	The PNC Financial Services Group, Inc.	PNC	PNC US	Ebrahim H. Poonawala
	Truist Financial	TFC	TFC US	Ebrahim H. Poonawala
UNDERPERFORM				
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	Canadian Imperial Bank of Commerce	CM	CM US	Ebrahim H. Poonawala
	Canadian Imperial Bank of Commerce	YCM	CM CN	Ebrahim H. Poonawala
	First Hawaiian Inc.	FHB	FHB US	Brandon Berman
	Prosperity Bancshares Inc	PB	PB US	Ebrahim H. Poonawala
	Texas Capital Bancshares Inc.	TCBI	TCBI US	Brandon Berman
	Zions Bancorp	ZION	ZION US	Ebrahim H. Poonawala

Disclosures

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Equity Investment Rating Distribution: Banks Group (as of 30 Sep 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R1]	Count	Percent
Buy	98	50.78%	Buy	81	82.65%
Hold	47	24.35%	Hold	35	74.47%
Sell	48	24.87%	Sell	36	75.00%

Equity Investment Rating Distribution: Financial Services Group (as of 30 Sep 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships R1	Count	Percent
Buy	156	53.24%	Buy	94	60.26%
Hold	79	26.96%	Hold	52	65.82%
Sell	58	19.80%	Sell	32	55.17%

Equity Investment Rating Distribution: Global Group (as of 30 Sep 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships R1	Count	Percent
Buy	1869	53.48%	Buy	1046	55.97%
Hold	828	23.69%	Hold	461	55.68%
Sell	798	22.83%	Sell	370	46.37%

[R1] Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster[R2]
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

[R2] Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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