RMB Mendon Financial Funds

Commentary: November 2018

November's choppy market was the result of multiple "wait-and-see" events. The Nasdaq Bank Index moved 1% or more on over 25% of the trading days. It was a month where the market was continually waiting: for a defined snapback from the ills in October; on the results of midterm elections; to see if Federal Reserve Chairman Powell would walk back his earlier, hawkish statements and become more dovish; and on the results of the Group of 20 (G20). Through all of this noise, we continued our core practice of frequent management meetings—meeting with over 50 institutions in the last week of November alone—to make sure we were current on the hyper-local economies and issues. What all of these meetings had in common were confusion around what was causing such violent downdrafts in valuations when outlooks for the underlying businesses were essentially unchanged. As one of our colleagues put it, "The market seems to be looking for a narrative to fit the price action." Macro recession fears generated by lower global PMIs, Brexit, slower housing data, lower crude prices, changing rate expectations, terrible market action with resulting fund unwinds/de-risking, and the overall duration of the cycle have affected positioning to the extent of creating a negative feedback loop that is ignoring positive industry fundamentals. The group never does well when it becomes a "trade" rather than an investment. PNC CEO Bill Demchak referenced this when he spoke at the recent Goldman Sachs U.S. Financial Services Conference, stating:

> I think we are much more constructive on the economy than certainly what you'd expect, given what we've seen today. The consumer remains very strong. Businesses remain very bullish. I think there's a bit of confusion in the market about how the stock market might react to trade tensions and geopolitical risks versus local GDP. It's a bit of disconnect now because stock market has large multinational earnings and U.S. GDP is service based and localized manufacturing. It feels really healthy localized, which is where we operate. So we're pretty constructive about it…If you look at some of the data, ISM [Institute of Supply Management] came out yesterday was really strong, with a 59 on top of a 57. I don't see how that says we're running into a slowdown here.

The U.S. midterm elections resulted in the consensus outcome of a divided Congress, with outlier fears of a "Blue Wave" keeping many market participants on the sidelines prior to November 7. With the Democrats gaining control of the House of Representatives, Rep. Maxine Waters will chair the House Financial Services Committee in the upcoming Congress. While we think there will be plenty of headlines for the larger banks coming from Ms. Waters' committee, we think there will not be much substance: most of the regulatory changes have already happened, and agencies are staffed. Even if anti-financial legislation makes it out of the Committee, it surely would not pass the Senate, much less be signed into law by the current president.

On the regulatory front, bank regulation continued to be tailored to fit the size and complexity of institutions. At the end of October, the Fed proposed a major overhaul of regulatory requirements for banks underneath the largest of U.S. banks. Randal Quarles, the Fed's vice chairman for supervision, said the proposed framework would recognize, "the character of regulation should match the character of the firm." Under the proposal, certain regional banks (those under $700 billion in assets) would see reduced requirements under the liquidity coverage rule, would no longer be subject to the advanced approaches capital framework, but would remain subject to the Fed's annual stress tests. The result of this proposal would be to remove disincentives for regional banks to grow, hopefully encouraging larger-scale mergers and acquisitions (M&A) once approved. Also during the month, the Federal Deposit Insurance Corporation (FDIC) announced that since its Deposit Insurance Fund's reserve ratio had reached the 1.35% mandated by Dodd-Frank, it is discontinuing the surcharge that banks over $10 billion in assets were required to pay. Ernst and Young estimated that in the second quarter alone, the surcharges totaled $1.25 billion. As most banks have not broken out their individual surcharges paid, we do not think this expense savings is included in analysts' forward estimates.

M&A remained robust with year-to-date aggregate transaction value 8% higher than full year 2017. In November, 22 deals were announced for a total deal value of $1.97 billion and a median deal value-to-tangible common equity ratio of 186.4%. By comparison, in November 2017, 22 deals were announced for a combined $1.37 billion and a median deal value ratio of 160.5%. Due to the mixed results banks have received this year when announcing M&A deals, we witnessed several compelling transactions during the month, including CenterState Bank Corp. (CSFL) acquiring National Commerce Corp. (NCOM). Both companies have been very acquisitive in the Southeast, and we certainly did not view NCOM as a near-term seller. However, CSFL recites the "Three M's" when evaluating mergers (Management, Map, and Math), and all three fully line up in this transaction, causing positive day one returns for both companies and outsized return potential for the combined entity going forward.

Despite the high amount of noise and drama that is evident in various markets, the positive fundamentals in the banking industry remain much healthier than current valuations suggest. The seemingly priced-in prospect of a near-term recession seems unlikely in our view. Financials as a group have become a risk-off trade that has spared none. The sector is very diverse, and we expect to benefit as this differentiation is recognized. Although a mature industry, it is still dynamic, and we believe it disingenuous to hold all possible negatives constant when evaluating the group. A good example of this adaptability is the $4.8 billion of buybacks announced since October 18. Know that despite our constructive outlook, we remain extremely attentive to any changes in posture from our management meetings and will pivot accordingly if necessary. Our 22+ year history of investing in this sector provides us with the institutional memory to analyze the current environment through the lens of the past cycles, allowing us to recognize certain mileposts and invest judiciously.

As always, we welcome your feedback, comments, and questions.
