RMB Mendon Financial Funds

Commentary: May 2019

During the month, the funds' bank index benchmarks were down four consecutive weeks in response to President Trump's May 5 tweet escalating trade tensions with China. Almost all of this move can be traced to the overall market's "risk off" posture and the ensuing ~35 bp decrease in the 10-year U.S. Treasury yields to levels not seen since September of 2017. We agree with a note published by BCA Research during the month stating that, "falling bond yields are being driven more by fears of a risk-off selloff in global equity and credit markets rather than rational pricing of future monetary policy or inflation expectations because of slowing growth."

Along with the changes in U.S. Treasury yields, market expectations for future short-term interest rate cuts changed markedly during the month, with the probability of a September rate cut starting the month at 31.8% and ending at 88.7% (source: Bloomberg). The most recent Federal Open Market Committee meeting minutes (released May 22) indicated that the Committee members, while remaining data dependent, believed that current monetary policy is appropriate and a rate cut was not contemplated at the time. With the Fed and the market being so far apart, Citi's rates strategist notes, "either domestic data or global trade developments need to rapidly support pricing a less-dovish Fed or failure to cut as expected will risk a significant tightening of financial conditions. Escalating trade tensions raise the risk of such a self-fulfilling cut scenario." Further complicating this outlook is that China may likely respond to the trade impasse by doing all it can to support domestic growth, thus adding a tailwind to global growth.

While we monitor all of the various global macro forces at work, we remain true to our process and, as such, conducted 90+ management meetings in May. This "boots on the ground" research continues to be vital to understanding domestic economic conditions and identifying inflections in regional economic outlooks. As an update, we believe that states with higher tax regimes continue to feel pressures from population out-migration and unsustainable budget and pension deficits. Southeastern and Sun Belt states, where the funds remain concentrated, continue to benefit but face tougher year-on-year comparisons due to the broader economic strength witnessed in 2018 when trade issues were not a potential hurdle. (One comment from a Northeast management team worth passing along was that the company noted that 16% of the bank's customers accounted for 80% of the bank's profitability, but problematically, that segment was the most geographically mobile). Uncertainty around trade and global growth is having some effect on Main Street, but that effect may be caused by Wall Street and its continued market volatility. Interestingly, it was reported in May that March was the first month ever where port trade value at Laredo, TX's inland port edged out that of the Port of Los Angeles for the top monthly trade value. Shortly after this report, Trump tweeted potential tariffs on Mexico, so we are following this and other port traffic trends closely.

In terms of our outlook, we are tracking two ways: From a bottom-up perspective, including the many meetings conducted last month with financial institutions, we see a high number of instances with idiosyncratic positives in capital return, cost-saving initiatives, and M&A opportunities. Credit continues to be benign to slightly normalizing, both because growth is still positive—if slower—but also as a result of how far underwriting standards were tightened post crisis. Most of our top positions remain skewed to the theme of optionality in markets and management; operating in areas of positive growth and led by management teams who are adept at adapting, executing, and creating return on the behalf of shareholders. From a top-down perspective, we continue to monitor the broader macro/trade situation for shifts in policy and the resulting impacts on global economies in general and financial services companies specifically, both for needed changes in the portfolio composition as well as more timely changes to positioning in the options portfolio. Although current results are being affected by continued distortions in macroeconomic and central bank policy, we remain committed to our process of identifying investable themes within the group and isolating long-term winners and losers that are often overlooked by generalists and/or passive capital.

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

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An investment cannot be made directly in an index. The index data assumes reinvestment of all income and does not bear fees, taxes, or transaction costs. The investment strategy and types of securities held by the comparison index may be substantially different from the investment strategy and types of securities held by your account.

The KBW Bank Index [BKX; PHLX/KBW Bank Index] is an unmanaged index comprised of 24 geographically diverse stocks representing national money center banks and leading regional institutions. One may not invest directly in an index. The KBW Bank Index performance data quoted above are total return numbers.

The NASDAQ Bank Index includes securities of NASDAQ-listed companies classified according to the Industry Classification Benchmark (ICB) Banks. The NASDAQ Bank Index performance data quoted above are total return numbers.

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