RMB Mendon Financial Funds

Commentary: July 2019

The month began in earnest with a closely watched nonfarm payrolls print the day after the Fourth of July holiday, keeping traders from checking out for the long weekend as it followed a particularly weak June number and was given a heightened informational weight as it related to the future path of interest rates. The payrolls number came in much stronger than expectations, which, along with the G20 meeting resulting in the U.S. and China agreeing to continue trade dialogue, made it increasingly unlikely that the first rate cut in over a decade would be 50 bps. The Fed did cut rates at the end of the month by the expected 25 bps plus announced it was ending the roll down of its balance sheet early. In between these two events, most U.S. banks reported 2Q19 earnings, and there was a burst of M&A transactions in the last two weeks of the month, with the Funds participating in several.

For the month, most banks beat or met estimates. Our management teams are working hard to drive value with the levers under their immediate control. Loan growth, expense control, higher fee income from mortgage and robust stock repurchases, as well as mostly benign credit were all positives against softer net interest margins (NIMs). Even though margins were weaker, in most cases, net interest income (NII) was higher than expected, which should serve as a reminder that spread income is a rate x volume equation, where volume (loan growth) plays a role that we believe has been underappreciated by market participants singularly focused on absolute rates or structures—as if that were all there was to know about a bank's value. As we have witnessed in the recent past, rate expectations can fluctuate wildly, causing the disconnects we currently see in today's market. Short-term timing factors can also come in play. One of the reasons for the pressure on NIMs in Q2 was variable loans dependent on market-based rates resetting well ahead of the Fed's cut, resulting in temporary mismatches between loan yields and deposit costs that will sort out over time. We're not being Pollyanna about margins and know there will be pressure, but we argue that bank balance sheets are dynamic, not static, and management teams do have discretion and tools to adjust sensitivities to changing rate environments. During earnings season, many management teams issued earnings guidance, taking all of this into account by incorporating 2–3 rate cuts, and provided investors with a more quantifiable measure of future earnings-per-share (EPS) sensitivities. Stephens, Inc. noted that of the banks in their coverage universe, banks in the Southeast and Southwest had the lowest magnitude of negative earnings revisions, supported by the underlying growth in those regions.

Mid-month, we saw a reversal in the group after the Nasdaq Bank Index (CBNK) bottomed at 67% of the S&P 500 before bouncing to 71% and finishing the month at 69% (the historical average is 91%). Potential reasons for the move were vast investor underweight positioning combined with better-than-expected numbers, banks strongly executing on buybacks, late-cycle credit worries not coming to fruition, and the abovementioned fine-tuning of EPS guidance. All of this against the continued push/pull macro backdrop of fund flows, growth vs. value, defensives vs. cyclicals, etc.

Keeping with the myopia of rate expectations, the market closely followed every economic data release for some glimpse into Fed Chair Jerome Powell's crystal rate ball. Much commentary discussed the "insurance" nature of Fed cuts, as mentioned in our last letter: "As such, we believe the ensuing cut(s) that the market expects are more of an "insurance" nature, meant to cushion against potential economic headwinds tied to the China trade war and other global macro/political uncertainties, not as a result of a material domestic economic slowdown." Chair Powell echoed this sentiment in his press conference stating, "We're thinking of it essentially as a mid-cycle adjustment to policy … What you've seen over the course of the year as we've moved to a more accommodative policy, the economy has performed about as expected with the gradually increasing support. Increasing policy support has kept the economy on track and kept the outlook favorable." Despite financials being down after the announcement, this is an extremely favorable backdrop for bank valuations as the Fed at this juncture does not want to commit to an undefined path of rate reductions, but rather, to its current policy intent on delivering a mild inflation overshoot, possibly resulting in easing at some point in the future, even as growth returns to trend or higher.

Passively managed money via sector ETFs did return to the group during the month with net inflows of $374 million, bringing net outflows to $4.3 billion. Active managers also seemingly re-engaged somewhat, with Barclays' large-cap bank analyst Jason Goldberg noting, "Yesterday we hosted our regular quarterly EPS preview conference call with the entire U.S./Canada Financial Services team. Of note, looking at the past 14 quarters, yesterday had the 2nd most participants. Interpret as you wish.” Additionally, 16 deals, with a total value of more than $2.4 billion, have been announced since mid-July, marking the busiest two-week period in recent memory. We think that there were many deals whose announcements were delayed by stock volatility and there remain many more to come, with the caveat that the timing will be volatility dependent.

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