Trust
must be earned

Amundi
ASSET MANAGEMENT

May 2023

Potential Fixed Income Opportunities in the US Banking Sector

INVESTMENT TALKS

Jessica FRATTURA
Senior Credit Analyst and Deputy Director of US Corporate Credit Research

Michael TEMPLE
US Director of Fixed Income Research

Jonathan DUENSING
Head of Fixed Income; US Portfolio Manager

- *Despite alarms of "financial system contagion" highlighted by recent headlines, we believe that recent banking failures are not representative of the industry as a whole.*
- *As a result of the relative attractiveness of issuer yields and spreads, we believe that US global systemically important banks offer compelling, long-term value.*
- *With the potential for stronger supervision and regulation across the sector, we suggest investors carefully select securities from larger, well-capitalized banks with diversified business models and conservative lending strategies.*

This is not 2008

A recent string of bank failures in the US, and UBS's surprise rescue of Credit Suisse, have rocked equity and fixed income markets, sparked concerns over the fundamental health of the banking sector, and provoked fear of a financial system meltdown reminiscent of the Global Financial Crisis (GFC). However, despite alarms of "financial system contagion" highlighted by recent headlines, we believe that these events are not representative of the industry as a whole. On the contrary, our assessment is that most banks are much better prepared to withstand financial volatility than they were in 2008-9. Today, as a result of the systematic application of much greater regulatory oversight, US banks have much higher levels of equity capital, better funding and liquidity, less leverage and much lower asset risk. It is our view that the banking sector's recent instability and subsequent spread widening have created an opportunity in bank bonds, particularly considering the potential for stronger supervision and regulation across the sector. However, fundamental analysis and credit selection will be crucial in identifying sound investments.

The "ABCs" of greater regulatory oversight

Under Basel III, the international regulatory framework created in response to the GFC, banks designated as "systemic," or important to the health of the overall banking system, remain highly regulated. Since the end of the GFC, the largest US banks have accumulated more than $600B of tangible common equity (TCE). This is double the amount of equity held prior to the GFC, which has helped reduce leverage across the sector. Regulatory reform drove these changes. An alphabet soup of regulatory acronyms evolved to help assess the safety and soundness of banks through factors such as liquidity, total holdings, and liability requirements. Additionally, in 2016, the Financial Accounting Standards Board (FASB) introduced the Current Expected Credit Loss (CECL) methodology in the US. CECL requires banks, at the origination of a loan, to estimate the potential for credit loss over the life of the loan, with the ability to make adjustments on a quarterly basis. Using this new methodology, the reserves built against potential losses, if appropriate, would reduce the need to add more when the revenue environment is already depressed.

Recent US bank failures presented a sharp contrast to the sector's Q1 2023 results

The latest US bank failures were the result of asset-liability mismatches coupled with highly concentrated deposit bases, a combination that led to concerns about the soundness of these institutions and precipitated a "run on the banks" that led to their eventual insolvency.

In contrast, the US banking sector's 1Q 2023 results provided evidence of the sector's resilience. For the vast majority of banks, these results were in line with the trends of the last 12 months, as banks saw stronger net interest income and stable credit and higher capital ratios, even as deposits continued to come off pandemic highs. While provisioning varied, banks generally increased their reserve levels in preparation for possible cyclical challenges in their loan books, reflecting modestly negative macro-economic assumptions. Despite good results, management teams highlighted growing conservatism as they focused their attention on deposit base concentration and quality, exposures to commercial real estate, the composition of their securities portfolios and deposit decline resulting from customers' shift toward higher-yielding products.

As fixed income investors, we find this focus on further de-risking a strong credit positive. However, we are also aware that, from a macroeconomic perspective, tighter lending practices and a greater focus on liquidity will lead to a reduction of credit availability to small and medium sized business – a clear headwind to economic growth.

Amundi
ASSET MANAGEMENT

"We believe US global systemically important banks (G-SIBs) can offer compelling, long-term value."

Potential opportunities across the US banking sector

The attraction of U.S. global systemically important banks

As a result of this fundamental view and the relative attractiveness of issuer yields and spreads, we believe US global systemically important banks (G-SIBs) can offer compelling, long-term value. We have historically favored systemically important US banks because of their tough regulatory capital and liquidity standards. They also generally demonstrate less concentrated deposit profiles and more diversified business models than smaller, regional banks. The US G-SIBs also undergo the US Federal Reserve's annual supervisory stress tests, which measure a bank's capital adequacy. As a result, despite the changing macro landscape, the U.S. G-SIBs remain well-capitalized and highly liquid. Furthermore, their Q1 2023 results and deposit levels outperformed the industry, indicating these institutions have been beneficiaries of the recent "flight to quality." We believe that the banking sector's recent spread widening vs. industrials has created long-term value, a relationship that should compress further in an environment where spreads tighten.

U.S. regional banks awaiting regulatory clarity

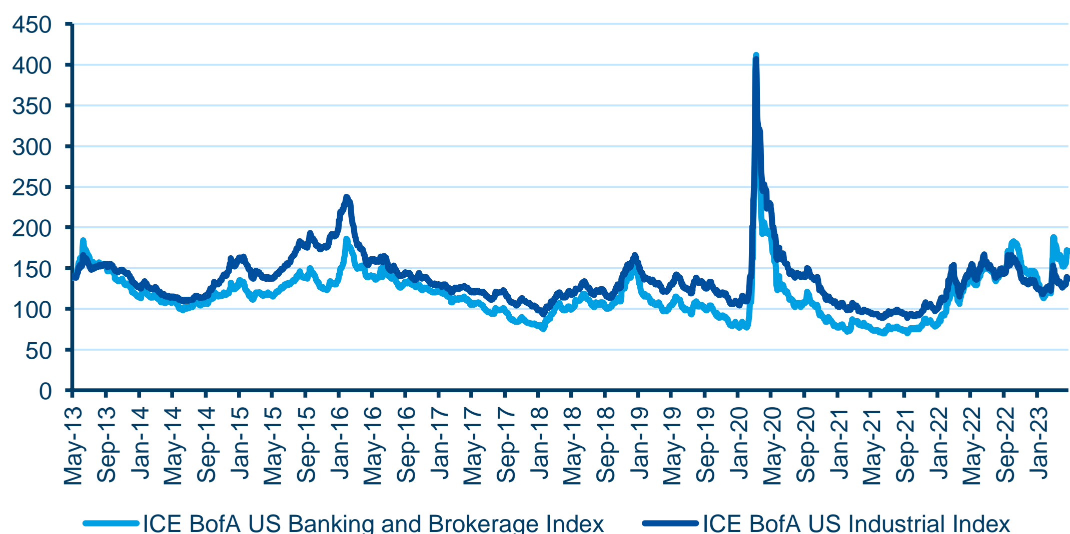
In 2018, the U.S. saw a partial repeal of the Dodd-Frank Act of 2010. The deregulation had an outsized impact on those banks with less than $250 billion of assets. The recent US bank failures have increased the discussion around the potential expansion of regulatory oversight through changes such as stricter requirements for capital determination and requiring total loss-absorbing capacity calculations for smaller institutions.

Despite less stringent capital and liquidity requirements, in recent years, the average large US regional bank has traded at lower spreads than the average US G-SIB. From our perspective, US G-SIBs have offered more long-term value given the incremental spread. While many of the larger regional banks demonstrate diversified business models with strong funding profiles that have benefitted from the movement of deposits out of smaller institutions, we need to consider the possible impact of a slowing US economy on the sector's asset quality. A change in financial conditions will likely lead to an acceleration in the deterioration of credit; the care with which banks have treated the underwriting of loans and loss expectations will be of significance.

Bank-industrial spread differentials

Banks are cyclical and tend to follow the direction of the economy. The graph below examines the ICE BofA US Banking Index and the ICE BofA Industrial Index Government OAS spread relationship within a historical context. The banking sector events of spring 2023 caused bank bond spreads to widen relative to industrials to levels reached only a few times over the last decade. In the second half of 2022, the bank-industrial spread relationship grew due to worries over the magnitude of Credit Suisse's restructuring plan, yet had recovered as anxieties eased around the Swiss bank's plans and the sector's broader fundamentals. In fact, in the weeks prior to the US bank failures and Credit Suisse's acquisition, the bank-industrial spread differential had once again compressed to within basis points of its nearly 10-year relationship average, which was a negative 18 bps. As of May 11, that relationship had widened to +35 bps, which, in our opinion, has created an opportunity.

Exhibit 1: US banking stocks vs US industrial stocks



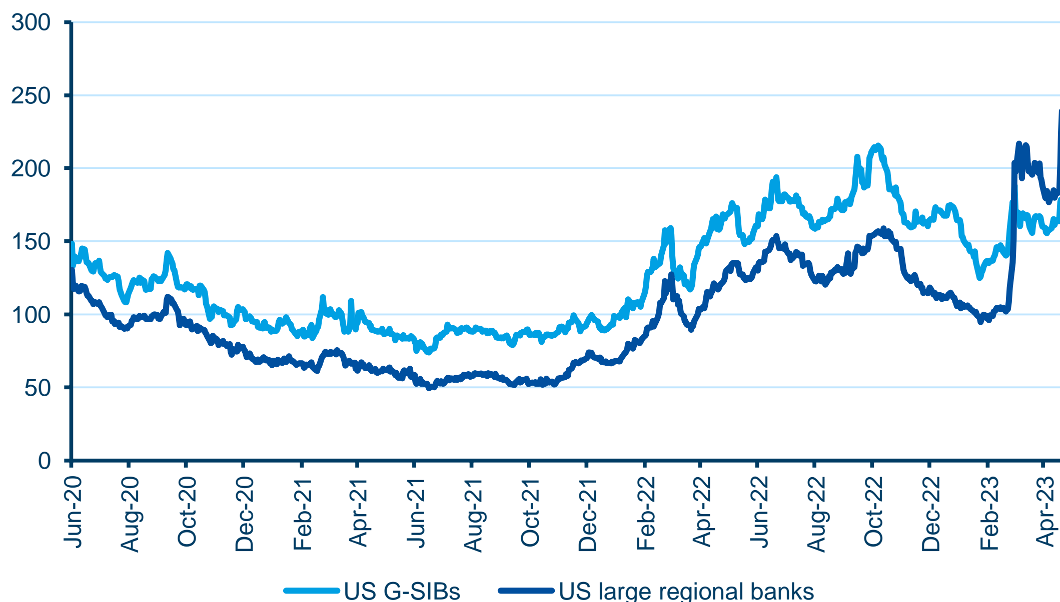
Source: ICE BofA US Banking and Brokerage Index, ICE BofA US Industrial Index. Bloomberg, last data point May 10, 2023.

"With the potential for stronger supervision and regulation across the sector, we suggest investors carefully select securities from larger, well-capitalized banks with diversified business models and conservative lending strategies."

The potential strength of US regional banks

The graph underneath demonstrates the average spread of senior unsecured notes between US G-SIB and large US regional banks over a three-year period. Despite their lower capital and liquidity standards, the average large US regional had traded at a lower spread than the average US G-SIB until March, as worries over the smaller banks' funding models and capital adequacy came into question. While we still have a preference for the US G-SIBs due to their diverse business models and higher regulatory obligations, larger regional banks that demonstrate conservative lending and prudent loss estimates, coupled with tougher capital and liquidity requirements, may cause the spreads between the two to normalize.

Exhibit 2: Senior bond spread differential between U.S. global systemically important banks (US G-SIBs) and U.S. large regional banks



Source: Bloomberg; last data point May 10, 2023.

Conclusion

Despite some fears of systemic weaknesses in the banking industry, recent US bank failures instead indicate flaws in the asset-liability management practices and liquidity maintenance strategies of a small number of banks. Rather than a cause for concern, the impacts of recent events – including the wider bank-industrial spread relationship and regional bank spread weakness relative to US G-SIBs -- point to a series of potential fixed income opportunities in the banking sector. With the potential for stronger supervision and regulation across the sector, we suggest investors carefully select securities from larger, well-capitalized banks with diversified business models and conservative lending strategies.

Definitions

Alpha – A measure of performance, gauged from the excess return of an investment relative to the return of a benchmark index.

Basel III – A set of international banking regulations developed by the Bank for International Settlements that aims to promote stability in the international financial system.

Tangible common equity – A measure of a company's physical capital used to evaluate a financial institution's ability to deal with potential losses. Calculated by subtracting intangible assets (including goodwill) and preferred equity from the company's book value.

Leverage – The amount banks are able to lend out as a multiple of their underlying equity cushion.

Important Information

Unless otherwise stated, all information contained in this document is from Amundi Asset Management US (Amundi US) and is as of [date]. Diversification does not guarantee a profit or protect against a loss. The views expressed regarding market and economic trends are those of the author and not necessarily Amundi US and are subject to change at any time based on market and other conditions, and there can be no assurance that countries, markets or sectors will perform as expected. These views should not be relied upon as investment advice, a security recommendation, or as an indication of trading for any Amundi product. This material does not constitute an offer or solicitation to buy or sell any security, fund units or services. Investment involves risks, including market, political, liquidity and currency risks. Past performance is not a guarantee or indicative of future results.

Amundi Asset Management US is the US business of the Amundi Asset Management group of companies.

Date of first use: May 18, 2023

Doc ID# 2898738

©2023 Amundi Asset Management US, Inc.

Amundi
ASSET MANAGEMENT