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FRANTIC MARKET / ENDURING ECONOMY

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* **Longest Recovery in Decades … Also the Slowest**
* **Valuation Reset for Equities is Largely Interest Rate Related**
* **Regional & Community Banks Have Re-Claimed Primary Lending Role … With Solid Deposit Access**

We see no material weakening in the economy except for housing, which is arguably among the most interest rate sensitive sectors. We see no fundamental reason for the current stock market weakness other than equity valuations acclimating to higher interest rates. While rate expectations have round-tripped more than once, we see no reason to dial back our interest rate outlook. Three more Fed interest rate hikes seem reasonable with an eventual move in long rates to the 4% vicinity.

Following three attempts, the October stock market correction remains only in partial repair with almost no sector untouched. It has been particularly virulent in financials. At 2633 (December 7th close) the S&P 500 Index is 10% below its 2018 high. This is not far from what a 100 basis point rise in long rates should extract from equity valuations based on a multi-decade regression analysis. An exhibit illustrating this is in the Appendix. Far worse, the NASDAQ Bank Index has collapsed 20% from its 2018 high. Absent severe economic deterioration, we conclude bank stocks are exceptional values.

While there is no shortage of probable reasons for a frantic market, many if not most relate to the economic cycle which is seen passing its usual age. We can poke holes in many popular explanations but the duration of growth since the last recession ended in mid-2009 is clearly longer than average. It is fair to say most investors now think in end-of-cycle or late-in-cycle terms. Financials are clearly cyclicals, so it is no surprise that they have retreated more dramatically than the market overall. Avoiding them until the next recession is an abundance-of-caution mistake.

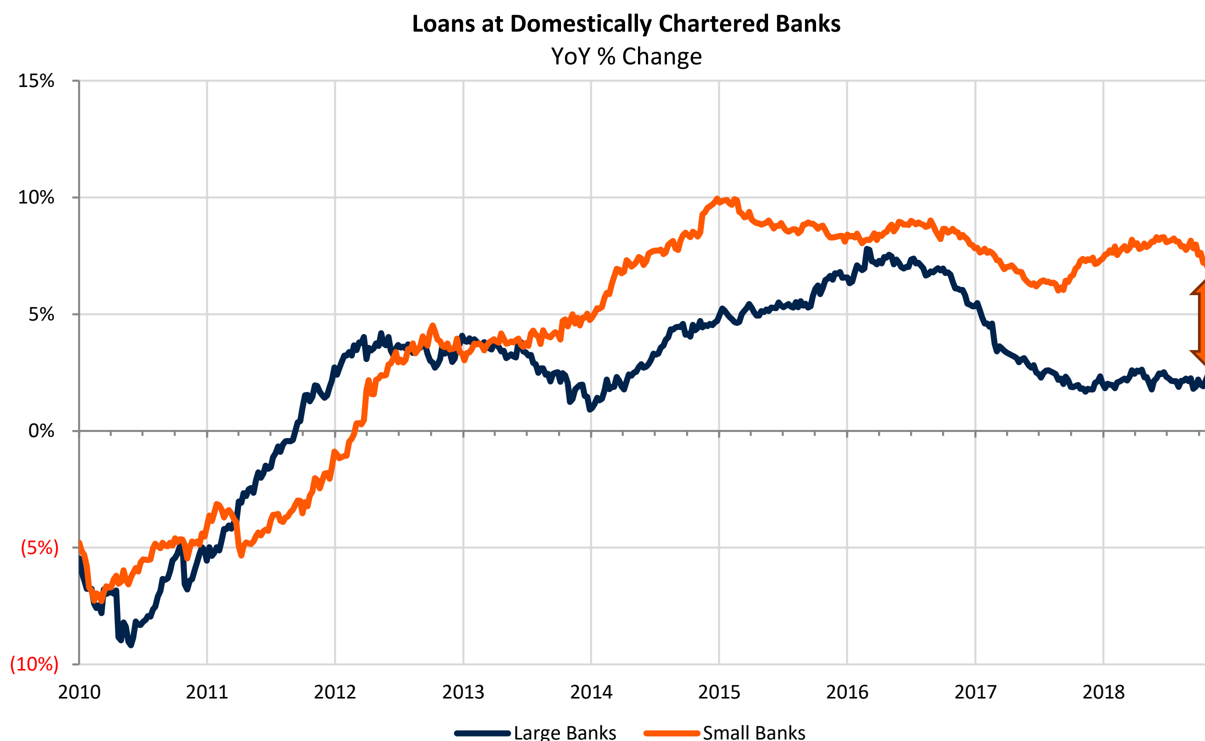
If we are correct, the cyclical movie is not over. The economic cycle will likely continue to lengthen. It may eventually decelerate to, perhaps, a 2% trend, but a recession seems improbable in the near term. Higher interest rate levels fundamentally weaken valuations, but not necessarily cyclical growth. Lower valuations are fully reflected in the broad market but are overdone in financials. Near-term forecasts for bank earnings essentially match that of the S&P 500, at least for 2019. The relative performance of bank stocks should rebound from here.

Deposit funding appears to be the biggest cyclical fear for regional and community banks as they supposedly lose deposit access to the largest banks. **This is a consensus view that is easily disproved by the facts.** We will address this first then return to macro issues.

The New Lending & Deposit Funding Epicenter: Since Dodd-Frank the capital burden on the largest banks has eclipsed the small. This is a dramatic reversal from history, when large meant safe. At least regulators and legislators thought so. Today the largest banks carry substantially higher economic capital against loan assets. This is a significant deterrent to lending.

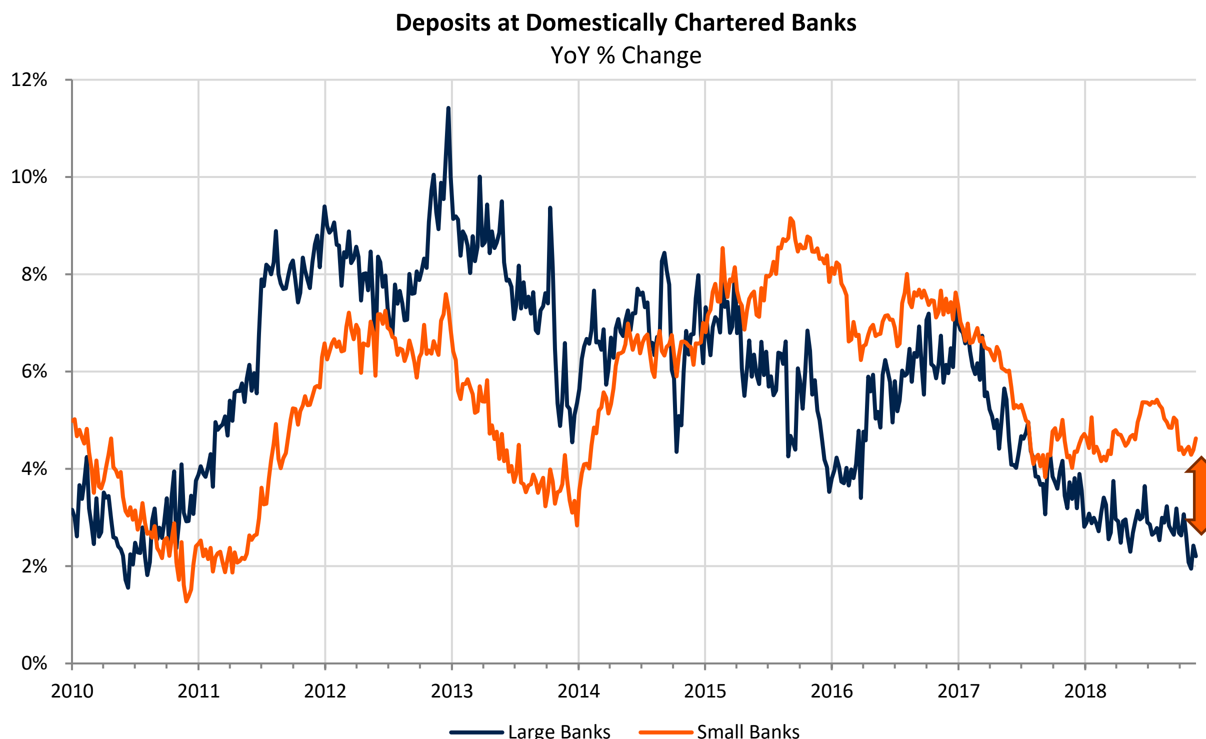
The top five banks alone represent 60% of U.S. banking assets and now carry at least 100 basis points in higher capital. Nearly half of the top 25 carry 150-250 basis points in capital surcharges for being Globally Systemically Important Banks (G-SIBS). Taking the G-SIBS' capital burden even farther above the rest, Total Loss Absorbing Capital (TLAC) requirements are adding an additional 18% against risk weighted assets. Unsurprisingly, lending has gone downstream in America.

The following two graphs show growth in deposits and loans since 2010 from the Fed's H.8 series for large and small banks. "Large" is defined as the 25 largest which currently works out to banks over $117 billion in assets. "Small" banks are defined as all domestically chartered banks outside of the top 25. The first graph clearly shows the widened gap in loan growth since 2013.



Equally striking is the second graph depicting deposit access. Since 2015 small bank deposit growth has outpaced the large by half. Since the end of 2015 bank deposits at small banks have cumulatively grown 18.3% as of September 30, 2018 compared to only 12% at large banks. Similarly the top five grew deposits by only 12.5%.

In absolute numbers the comparasion is more dramatic. Small banks gained a disproportionate $634 billion in deposits compared to $771 billion at large banks for this period, yet the H.8 “large” banks hold twice the assets! Same disproportion in lending. Regional and community banks have actually become the dominant lenders in 2018, growing 2.4 times more loans year-to-date than the largest 25 in absolute terms!



Source: Federal Reserve System H.8 (“Large” = top 25 domestically chartered), Sandler O’Neill

An Extended Economic Cycle Based on Persistently Modest Pace: Returning to macro issues it is appropriate to address why we see rates ultimately higher and why we view late-in-cycle thinking as premature at the very least. Of course, they are related. Recent economic statistics simply show no loss of momentum. Strategic and investment risks will most likely become unintended consequences of undue caution. Remaining on recession-watch for the duration of this economic cycle is counter-productive.

Consumption spending certainly hasn’t skipped a beat and retail sales growth has been averaging over 6% following a 4.7% pace in the first quarter. Personal consumption spending (PCE) was up 5.2% in the latest quarter. Business spending was believed to be in decline as recently as a month ago. CAPEX was presumed to be in its end-of-cycle phase. However, late November GDP revisions virtually doubled the sequential gross private fixed investment comparison. Fixed investment was up a brisk 8.6% in the latest quarter compared to a year earlier.

The tax changes from a year ago have also influenced growth in two broad ways. Consumer tax relief is adding disposable personal income in stepwise fashion. A onetime elevation in the rough vicinity of $200 billion will likely be incorporated in GDP with perhaps at least half adding directly to annual consumption spending and the remainder enhancing savings and reducing debt. The full step should be in place by next year.

An even larger elevation to business investment shows a $300 billion upswing over the last seven months. Unlike the step up in personal consumption the gain in business investment should also produce ongoing GDP growth enhancement to the extent such investment has a multiplier effect in adding jobs or enhancing productivity. Estimates for both vary widely but clearly 3+% real GDP growth is now present and could extend the economic growth cycle.

Employment growth, despite sequential variations in monthly data, has been remarkably consistent. The November jobs number, characterized by the media as "somewhat weak," was nonetheless up 1.7% over the prior year period, identical to October and in a tight range for the last seven years. The labor force was up 1.4% in November, identical to October. While a more volatile data series, it has been moderately accelerating over the past few years yet remains below jobs growth, suggesting more wage inflation. Wage inflation, long thought missing this cycle, actually appeared five years ago. Slow and moderate. Just like everything else in this cycle.

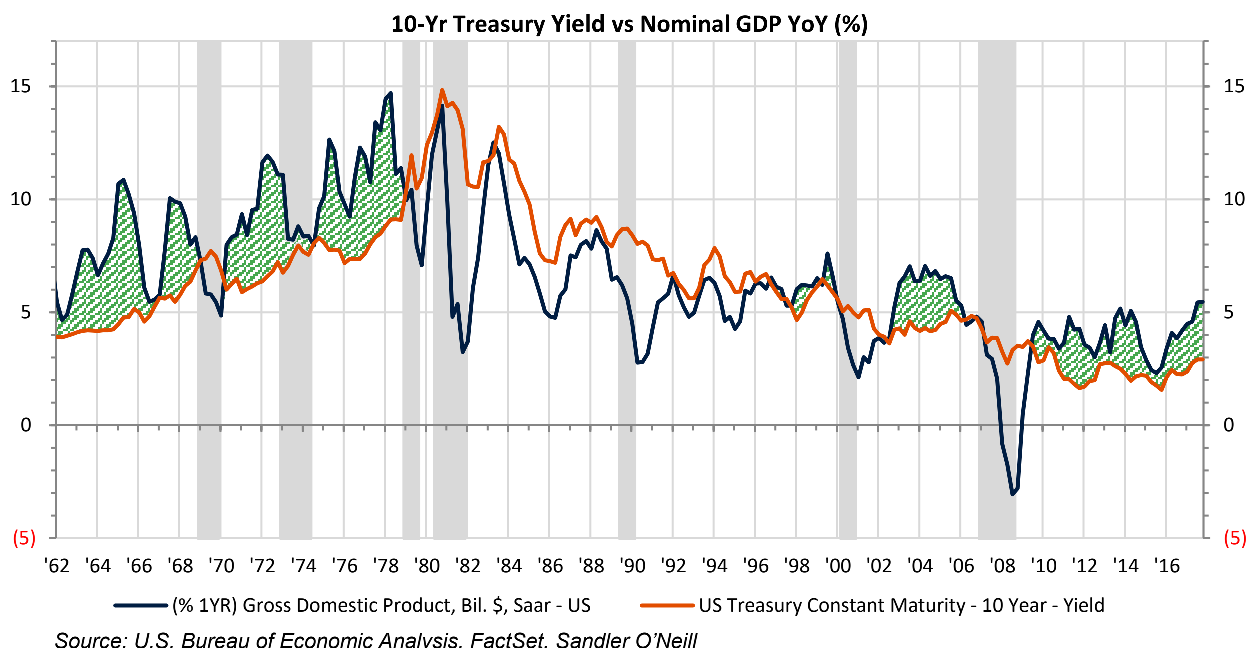
	Jobs YoY	*Jobs to LF Ratio*	Labor Force YoY	Hourly Earnings YoY
2005	1.7%	*1.3*	1.3%	
2006	1.8%	*1.3*	1.4%	
2007	1.1%	*1.0*	1.1%	3.4%
2008	-0.5%		0.8%	3.0%
2009	-4.3%		-0.1%	2.8%
2010	-0.7%		-0.2%	1.9%
2011	1.2%		-0.2%	2.0%
2012	1.7%	*1.9*	0.9%	**1.9%**
2013	1.6%	***6.0***	0.3%	**2.1%**
2014	1.9%	***5.6***	0.3%	**2.1%**
2015	2.1%	***2.7***	0.8%	**2.3%**
2016	1.8%	***1.4***	1.3%	**2.6%**
2017	1.6%	***2.2***	0.7%	**2.5%**
Last 6 Mos	1.7%	***1.6***	1.1%	**2.9%**
2018 YTD	1.6%	***1.6***	1.0%	**2.8%**
November	1.7%	***1.2***	1.4%	**3.1%**

Source: Bureau of Labor Statistics

Interest Rates: There is never a shortage of thought or microscopic scrutiny over Federal Reserve policy and intent. We assume the current economic cycle is far from over and that alone will require further normalization of risk-free interest rates. Having used this phraseology, along with the concept of interest rate neutrality, Fed analysts have come up with multiple estimates to quantify neutral / normal.

Our contribution to this exercise has been arithmetically simple. Long rates or the term premium should be close to the nominal rate of GDP growth and short rates should be lower by some historical average. Heretofore the Fed could only influence the long end of the curve while enjoying virtual fiat over short rates.

1) Nominal GDP growth is currently over 5%. It may eventually slow to 4% -- from 2% real growth and 2% inflation. Long rates are a long way from either level. The following exhibit shows the 10-year U.S. Treasury rate against nominal GDP growth for nearly six decades. The shaded green highlights periods when the 10-year was meaningfully below nominal growth. The initial period for this condition was a lengthy one and persisted until Chairman Volcker applied extreme monetary restraint. The next such period preceded and presumably abetted the so-called Great Recession. The third period was purposely fostered to recover from this severe downturn. We are still in this period of abnormal accommodation.



Source: U.S. Bureau of Economic Analysis, FactSet, Sandler O'Neill

2) By virtue of its considerable balance sheet following three rounds of Quantitative Easing (QE), the Fed now has the capability to directly affect long rates by pacing its QE withdrawal program. This is the first time such capability has existed in modern history. And it exists in many other central banks around the world. This doesn't mean they will use it, although it has apparently been considered by the Fed.

3) The continuing expansion of U.S. Government debt, combined with lackluster foreign demand and declining Fed holdings, add further pressure for higher interest rates. The primary budget deficit has risen over 40% this year with the estimated net new supply of Treasuries over 50% higher. The Fed balance sheet of Treasuries alone is now declining $30 billion per month.

4) We have included our updated supply/demand exhibit in the Appendix capturing this growing imbalance for U.S. Treasuries. Two-thirds of net demand historically came from the Fed and foreign buyers. That is no longer the case. Domestic buying will soon need to be $130 billion per month, over double what it was during the 2008-09 crisis.

5) The Policy Rate historically averages about 120 basis points below the 10-year over the long term. Assuming a 10-year rate at the midpoint of our current 4-5% theoretical growth in nominal GDP suggests a Fed Funds rate approaching 330 basis points. This is toward the high end of the Fed's 2019 dot plot range and would imply three more 25 basis point hikes. In reality the short end of the interest rate curve will largely be data dependent as interpreted by the Fed. The long end of the interest rate curve should eventually be determined by the trend in GDP growth and core inflation.

6) Since the first Fed rate hike, net interest margins for banks have exceeded analyst estimates for eleven consecutive quarters. Although deposit betas became an obsession loan yields incrementally stayed ahead of deposit rates until recently. It is fair to say that net interest margin recovery is generally complete. Loan growth will become the primary revenue and earnings driver for most banks going forward.

Late-In-The-Cycle? We have long argued, based on various "markers" or benchmarks on the economic timeline that the recovery beginning in mid-2009 has followed a remarkably similar chronology from previous recessions. Only the timeline was altered and rather consistently so by between 2.5 – 3.0 times in duration. An exhibit with some of these markers is included in the Appendix. We have argued that demographic changes explain most of this elongation. Labor force growth provides an upper bound on economic growth. As a result it likely provides more wage inflation impetus barring any rebound in the participation rate. Labor force growth broke trend almost two decades ago and is why long-term growth may decelerate. This is no harbinger of recession however.

Recessions historically have clear triggers outside the economic cycle, thus the adage that economic cycles "never die of old age." There can also be more than one trigger or catalyst for recession. And they are rarely foreseen with much clarity.

Based on market gyrations and media drama it is clear the hunt for the next recession trigger is in full swing. It is instructive to review past triggers at least in broad terms. There have been thirteen U.S. recessions since the Great Depression ranging in duration from six to eighteen months. There were recurring patterns. In fairness most recessions resulted from more than any single factor but we think the following is representative of the primary factors.

The Fed: Restrictive monetary policy was actually the most common trigger or major factor in at least half of these recessions. But it has been 37 years since the Fed was considered the proximate cause of recession. While the course of interest rates today consumes enormous commentary and analysis, rates are barely positive in real terms.

Oil: Perhaps surprisingly, oil was a major ingredient in three of the last six recessions, starting with the 1973 Arab / OPEC embargo. Oil prices clearly disturbed markets in 2014, ironically because of their decline, not rise. This year oil has done a round trip. But with geographically broadened supply few would consider it a likely recession trigger.

Real Estate: Real estate bubbles lay claim on two recessions. Commercial real estate was an important factor in the 1990 recession and residential real estate, of course, dominated the 2007-09 recession.

Residential home prices nearly doubled in relation to household income and produced a more virulent recession if for no other reason than its sheer market size. Only government debt eclipses the residential mortgage market. Commercial real estate returns as a reasonable trigger contender particularly

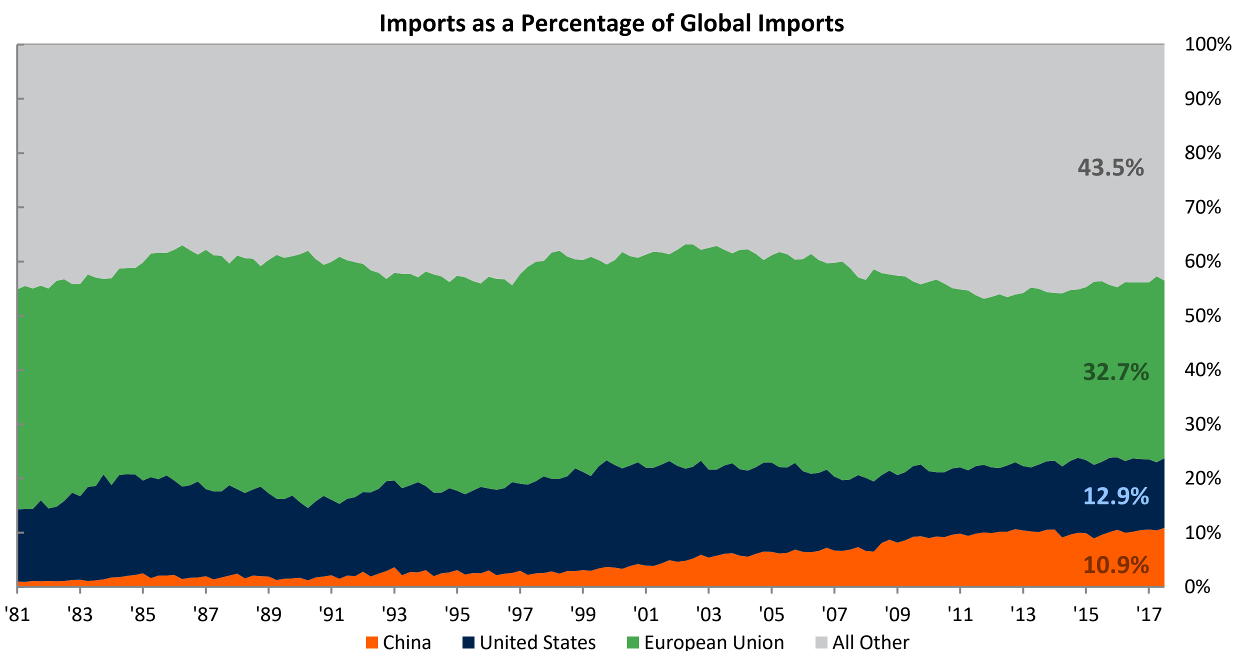
considering fierce CRE lending competition from nonbanks and ascending rates. But few see it graduating into recession.

Global Trade: The trade dispute with China, while temporarily at a truce, is still receiving the lion's share of attention. We see at least one ameliorating factor and one possible case of mistaken identity.

The ameliorating factor is that global trade already collapsed after the financial crisis. Prior to 2007 global trade had been growing a full 2-1/2% greater than global GDP for at least two decades (see Appendix exhibit.) After a short post-crisis trade rebound, global trade is growing by barely ½% per annum above the trend growth in global GDP, and IMF projections suggest little difference in this narrowed pace through 2025. This does not mean immunity to further damage, of course, but it does suggest that local, domestic economic expansion has generally lost much of its lift from a vibrant export market.

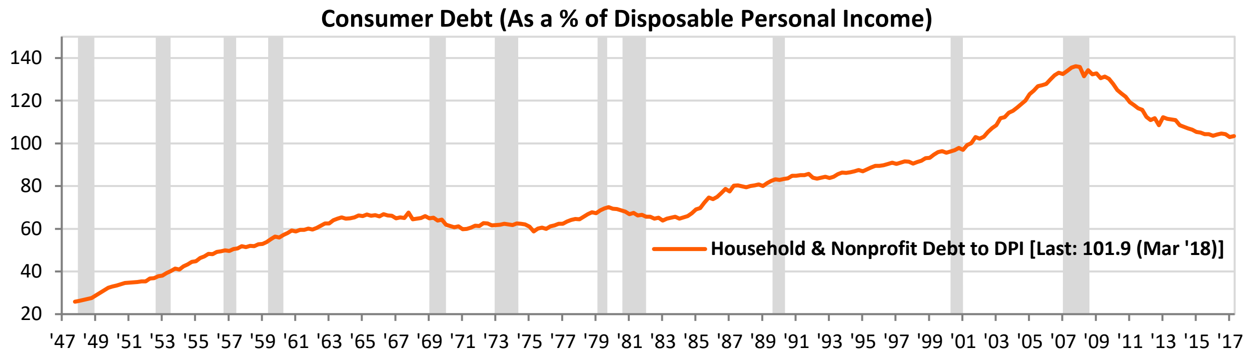
The mistaken identity is the misplaced view that a trade dispute with China is the biggest threat. This view is understandably driven by China's outsized contribution to global GDP growth for many years. But one nation's domestic economic growth, however large, does not directly influence or impact growth in other nations. Only the trade related portion has such influence. The exhibit below captures "final" demand by geography in context with the global import pie. China's share of that pie has tripled since the late 1980s. But that share is still less than a third of the collective demand from the European Union!

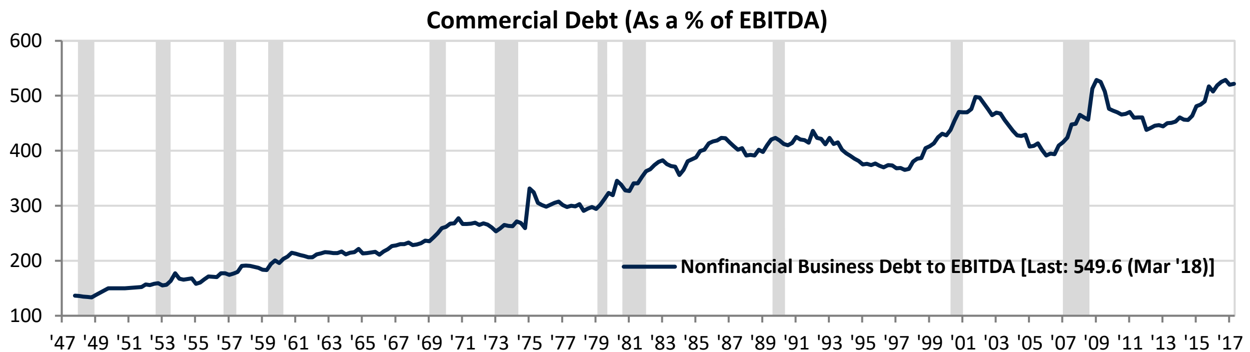
Worry about Europe, not China. Europe remains a project with elements of a common monetary system without the balance of a common fiscal system. As such it is inherently unstable. Nationalism and populism have exposed this weakness. Brexit is clearly the current focal point. There are potentially similar forces in many other EU members. The final Brexit outcome has the potential to spawn similar referendums. Ironically an orderly, less painful departure for Britain could encourage others to follow whereas a disorderly one could have the opposite effect.



Source: IMF Direction of Trade Statistics

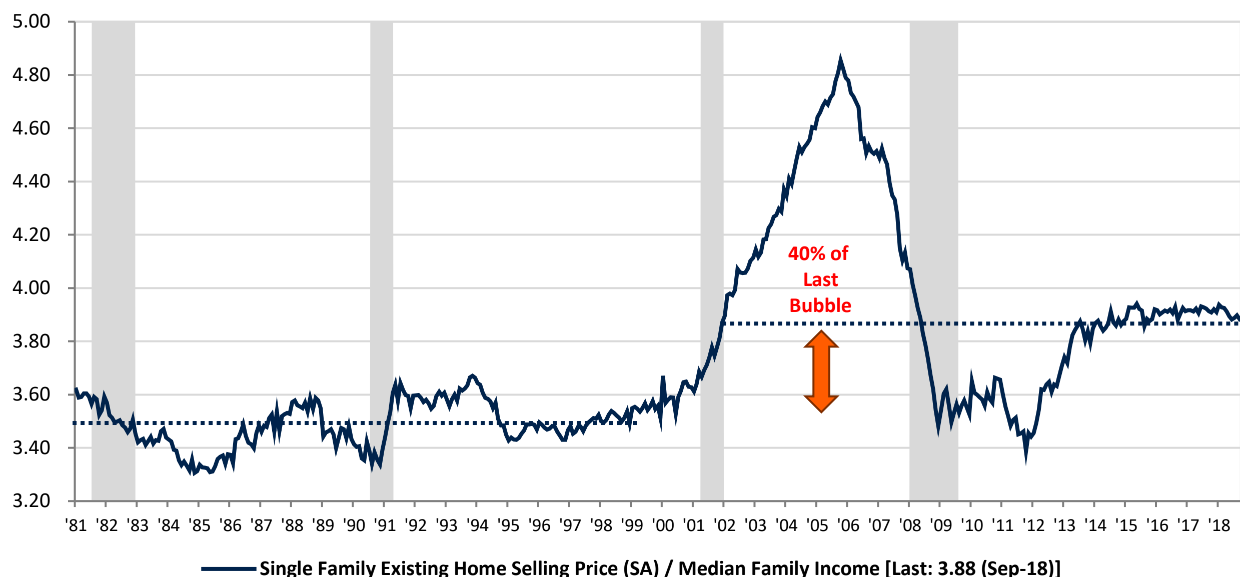
Private Sector Leverage: Most recognize the risks in subsets of credit but few conclude it worthy of a starring role in the next recession. Bank credit delinquencies have shown no material deterioration across the large categories of credit. Areas appropriately under scrutiny include agriculture, commercial real estate, health care, and leveraged lending. Narrow channels within consumer subprime and real estate development have shown sporadic strain but nothing remotely rises to the macro level. Household debt is down and commercial debt appears manageable.





Source: Federal Reserve Z.1, Bureau of Economic Analysis

Housing Market: Oddly receiving little attention, home prices and the underlying residential mortgage market could become a potential trouble spot as interest rates rise. A debacle may be off the table, but we continue to inflate housing prices ahead of family incomes. The exhibit below successfully warned us well ahead of the 2006 collapse. The range of home value to family income held tightly to a 3.5:1 ratio. By 2002 it had clearly moved beyond that range, reaching a breaking point at 4.9:1. We have been above the 2002 yellow warning light for six years. At least it has been stable at that level but rising interest rates could strain debt service.



Source: US National Association of Realtors, Sandler O'Neill

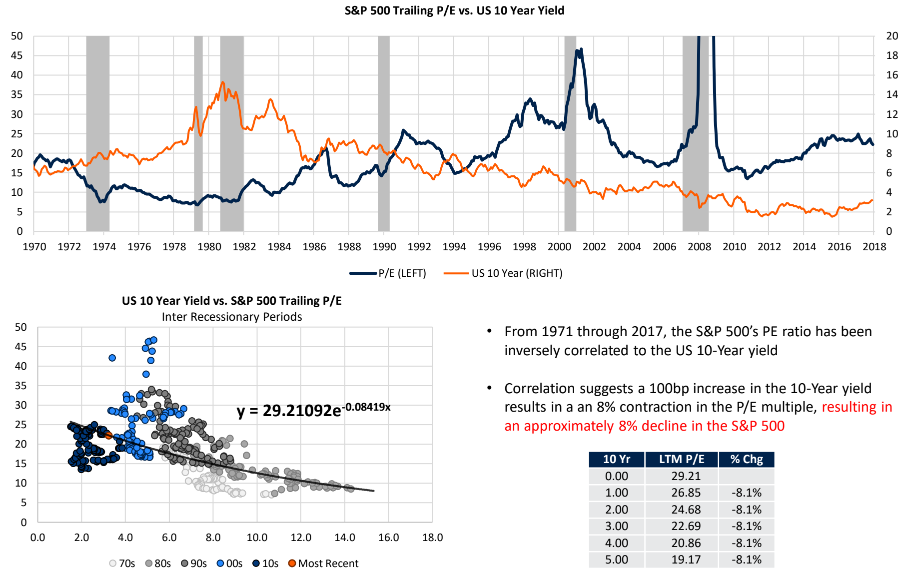
Higher Interest Rates: We already noted that interest rates are still too low in real terms to be considered an immediate threat for recession in isolation, even assuming further increases contemplated by the Fed. But in context with a near decade of ZIRP and QE even a return to some neutral level has the potential to disrupt economic momentum and/or deflate unintended consequences – read bubbles – generated after this extraordinary period of monetary accommodation. The housing sector is the most prominent cyclical laggard as residential mortgage rates begin their climb. But it is the only laggard at the moment.

Returning to equity markets, the 10-year Treasury rate breached 3% in mid-September, moving above 3.2% in early-October. In our view this was a tipping point for investors. September 21st was the high for the S&P 500 index. The recent 10-year rate retreat was calming but readily offset by other macro concerns. We are assuming 2600-2700 is now a reasonable "neutral" range for the S&P 500 incorporating further upside to interest rates. Recent rebounds have failed.

Conclusion: With the above said we do not find it helpful to think between bull and bear market terms. Nor is it helpful to think between recovery and recession. This is a market transition, an acclimation to a monetary normal. What that normal will be mostly depends on the forward economy. Accompanying this transition is illiquidity in both the debt and equity markets. Algorithmic trading clearly adds frantic drama, but the enduring economy should be respected. The mid-cap banks are not only oversold in our view, their role in credit intermediation is in an unrecognized revival.

APPENDIX

Equity Valuations Negatively Correlated to Treasury Yields



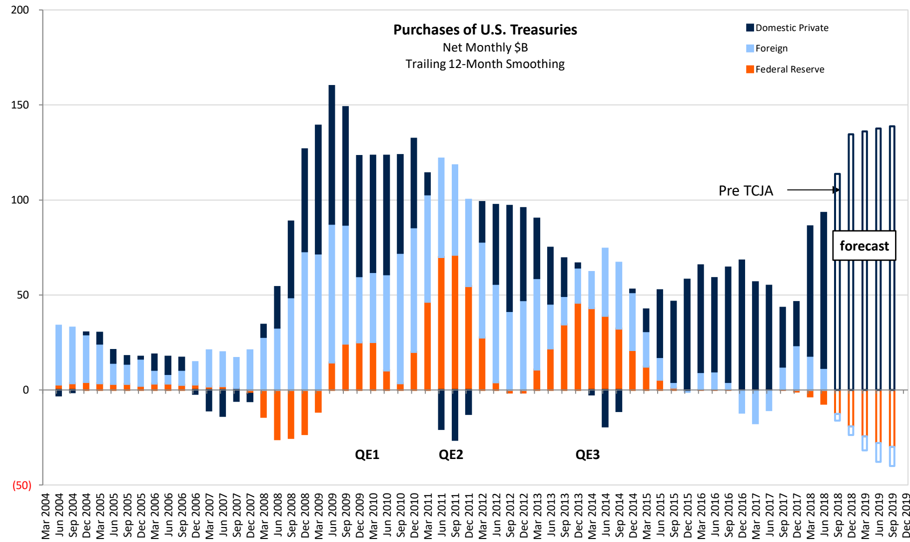
- From 1971 through 2017, the S&P 500's PE ratio has been inversely correlated to the US 10-Year yield
- Correlation suggests a 100bp increase in the 10-Year yield results in a an 8% contraction in the P/E multiple, resulting in an approximately 8% decline in the S&P 500

10 Yr	LTM P/E	% Chg
0.00	29.21	
1.00	26.85	-8.1%
2.00	24.68	-8.1%
3.00	22.69	-8.1%
4.00	20.86	-8.1%
5.00	19.17	-8.1%

As of November 2018

Source: Robert Shiller Online Data
Note: The PE10 ratio or 'Shiller PE ratio' divides the current price by average earnings over the last decade.

Projected Supply of US Treasuries Rising Sharply
While Fed Demand Increasingly Negative & Foreign Demand Minimal



Sources: net supply history and projections: CBO & UST; demand projections: SOP

Normal Economic Cycle Markers … Reveals Cycle Extension

- The post-2009 cyclical pattern is surprisingly like past recovery cycles … with one BIG exception:

  The time scale has been elongated by 2.5x – 3.0x

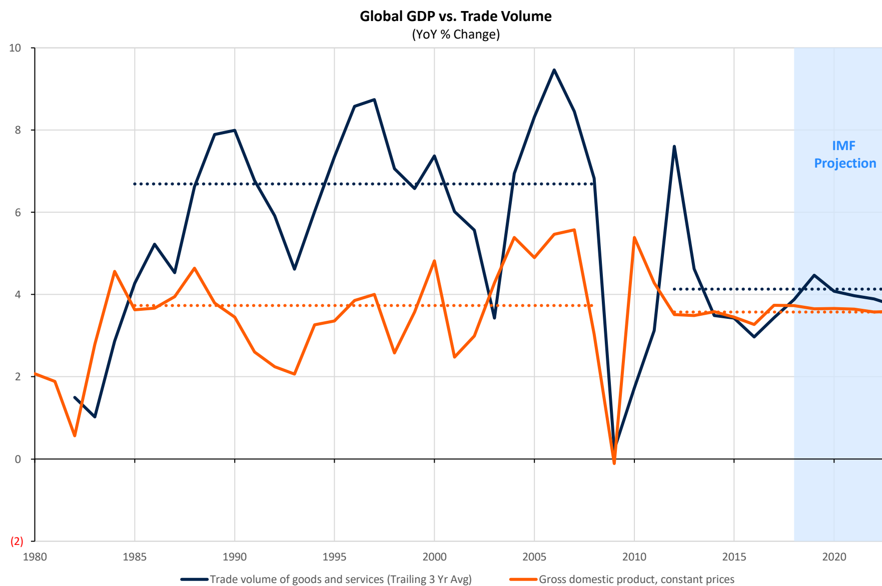
- **Time frames to regain pre-recession levels versus average of previous 3 recessions:**

GDP (Real)	.....	took 14 quarters versus 6 quarters
GDP (Nominal)	.....	took 10 quarters versus 2-4 quarters
Consumer spending (PCE)	.....	took 3 years versus 1 year average
Jobs	.....	took 6 ½ years versus 2 ¼ years
Bank business loans (C&I)	.....	took 7 quarters versus 2 quarters
First Fed Hike After Recession	.....	took 6 ½ years versus 2 years

- Simplistic analysis presumes past recessions have occurred about every 8 years
  … The above argues for much longer barring some external, non-cyclical event intervenes
  … Fed (uniquely) not trying to slow the economy with rate hikes

- Bank loans averaged 90% gains between last 3 recessions …. Currently up only 45%

Trade No Longer Exceeding Domestic Demand



Source: International Monetary Fund (World Economic Outlook Database, October 2018), Sandler O'Neill

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