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S&P Global
Market Intelligence

Blog:
In Q4 '16 earnings season, Street anticipates brighter outlooks from banks

By Kevin Dobbs **January 4, 2017**

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As earnings season approaches, analysts eagerly await updated outlooks from community bank executives, hoping to get new guidance on the impact of rising interest rates as well as the likely effects of potentially sweeping changes in Washington, D.C., from corporate tax cuts to regulatory rollbacks.

What is more, a recovery in oil prices provides an impetus to take special interest in banks that operate in energy-heavy states. And a surge in financial stocks over the past couple months that has provided acquisitive banks stronger currencies with which to pursue mergers and acquisitions adds reason for analysts to seek updates on executives' deal-making perspectives.

A long-anticipated move by Federal Reserve policymakers to lift rates last month may have pushed up fourth-quarter interest income at some banks, but because the change occurred so late in the quarter, any impact likely was modest. Analysts said of greater interest is bankers' forecasts on how rising rates, including the possibility of multiple additional rate increases, could enhance earnings throughout 2017.

"Rates will be a huge thing," Jefferson Harralson, an analyst at Keefe Bruyette & Woods Inc., said in an interview.

The latest increase — the central bank lifted its key interest rate by 25 basis points after its December meeting — was the only bump the Fed made last year and only the second such move since prior to the 2008 financial crisis. Asset-sensitive banks rely on the interest income they earn on lending, and while they typically pay more interest for deposits as rates rise, many banks historically have been able to charge even more in interest on the credit they extend, enabling them to widen the spread between their liability costs and their lending income, boosting profitability.

That explains why banks as a group have eagerly anticipated a higher-rate environment, as analysts have noted. Following the December Fed meeting, policymakers released projections indicating they could lift rates three more times in 2017, thanks to a strengthening economy.

"It appears that the Fed may continue to tighten rates in 2017, leading to still higher rates," Merion Capital Group analyst Joe Gladue wrote in a report.

He agreed that could prove positive for many lenders, both because higher rates could bolster net interest margins and because an upward shift on the rate front usually reflects greater economic momentum that results in higher levels of loan demand.

Gladue cautioned, however, that if rates rise too quickly, outpacing actual economic activity, credit can become too expensive and this would "choke off" loan demand.

Early in 2017, banks that are active in the residential mortgage business are likely to see the first signs of this, as refinance activity tends to dry up quickly when rates rise. "Mortgage banking, if it is not off yet, it will be," Rick Weiss, managing director at Ambassador Financial Group, said in an interview.

Weiss also said bankers' expectations around political changes in Washington will be top of mind during earnings season.

Most notably, analysts are sure to seek color on what bank executives think about the potential impact of President-elect Donald Trump's calls to lower the corporate tax rate from 35% to 15% and to peel back layers of regulation that have weighed particularly heavily on community banks. Though specifics on both fronts are in short supply — Trump does not take over the White House until later this month — analysts say bankers are surely beginning to study how lower taxes and regulatory costs could boost their bottom lines in future quarters.

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Weiss noted that positive developments on those fronts have helped fuel a strong double-digit boom in bank stocks since the Nov. 8 presidential election. “That’s the bull case,” he said. “It will take time for all these things to work through the system, but getting a sense of how banks are starting to think about all this, there will be a lot of interest there.”

KBW’s Harralson agreed. “People will want to get under the surface and see what a change in the tax rate and the regulatory environment could really mean for earnings,” he said.

He also said that, given a recovery in oil prices in the second half of 2016, analysts are sure to focus on banks with substantial energy exposure, hoping to see signs of strengthening lending books and brighter outlooks in general. Many such banks had suffered in recent years alongside their commercial clients amid a slump in oil prices.

“Energy updates will be big,” he said.

Analysts also said that, following the recent run-up in stocks, they will look for commentary from acquisitive banks about their ability to get more deals done in 2017, given that their improved stock valuations provide them stronger currencies with which to pursue targets. There were fewer bank deals announced in 2016 than the previous year, though 2015 was a notably active year.

Compass Point Research & Trading LLC analysts said in a report that they expect 2017 “will bring substantially more M&A with richer pricing.” On the heels of the rally, they added, “we believe that M&A multiples will expand and deal pace will accelerate as bank buyers can now offer per share prices meeting sellers’ expectation hurdles.”.

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