Vol. IV, No. 15

TOM BROWN'S BANKING WEEKLY: 4/12/19

Financial Services Insights and Intelligence

FIRST WORD: CEO bank meeting. My friends at bank technology consultant Cornerstone Advisors (who do great work for mid-size banks, by the way) were kind enough to invite me to their annual bankers' meeting in Dana Point, California this week. It was a very worthwhile session. CEOs from seven banks, both public and private, with assets ranging from $2 billion to $10 billion, sat down with three Cornerstone consultants and me for a day and a half to discuss the biggest issues their companies are facing, and how they're handling them. I've attended these meetings before, but this one was a little different, as I sensed more concern than in the past, particularly regarding the durability of the expansion, the direction of interest rates, and the ascendance of the big banks as serious competitors. We discussed a number of issues, and I'm sure the bank CEOs left the meeting with ideas on how to tweak their operations, but no major breakthroughs. Here are more specific thoughts:

All well-positioned now. These bank CEOs all have clear strategies, all of which are surprisingly different from one another. As marketing guru Seth Godin would say, each has his own purple cow which differentiates his bank from the pack. One bank has an unusually large benefits-administration business, another has a large homeowners association specialty, and a third has 40% of its deposits in DDAs. One bank has close to 90% of its loans in suburban commercial loans, and another has created an attractive bank out of converting a mutual thrift seven years ago. And one has an unusually large SBA lending business. All the banks' models are different, and all successful, and they all want to find ways to improve their profitability. These seven showcase one of the most notable aspects of banking in the U.S., that doesn't exist anywhere else in the world: there are 5,000 banking institutions in the country that are successfully competing against companies that are 40 times larger. I'd argue they succeed by focusing on what they do well rather than trying to do everything.

But there's concern about the environment ten years from now. Unlike at prior Cornerstone meetings, there was more uncertainty expressed as to what the competitive environment will be like for community banks ten years from now. No one had an answer he thought was definitive. In fact, there was even some doubt if there will be community banks in ten years, given the incredible pace of change occurring in the banking industry generally. The consensus was that there will be a role for them, but we had trouble nailing down what exactly that role would be.

No more reliance on NSF fees for growth. I argued that NSF fees industrywide have plateaued at around $12 billion over the past two years, and that they'll gradually be competed away going forward, notably as the big banks exert their heft and as alternatives from fintech startups emerge. For the first time in discussing this topic with bankers, I got no pushback. Rather, I got the sense that while the CEOs aren't budgeting for their NSF fee income to go away any time soon, they aren't planning for any growth, either.

Concern about funding and the margin. Everyone expressed some concern about the ability to increase deposits going forward, and the ability to maintain net interest margins. No one was anticipating a higher margin. When I said the current outlook of no more fed funds rate hikes this year was the best that could be hoped for, I got some disagreement. Still, this seems the best realistic possible outcome. If the Fed keeps raising rates, consumers will speed up their move out of low-rate deposit accounts into higher-yielding alternatives, pressuring margins. Further, if the economy then weakens and the Fed cuts rates, asset yields would fall faster than deposit costs, even as credit costs rose. If I'm correct that the economy will continue to grow at 2% to 3% over the next 18 months and bank loan growth runs in the mid-single digits, these CEOs will be spending more time focused on deposit growth strategies.

Technology investments. No one in the room felt his institution was behind in tech investment, but all were concerned about the ability of their management teams and boards to keep up with the

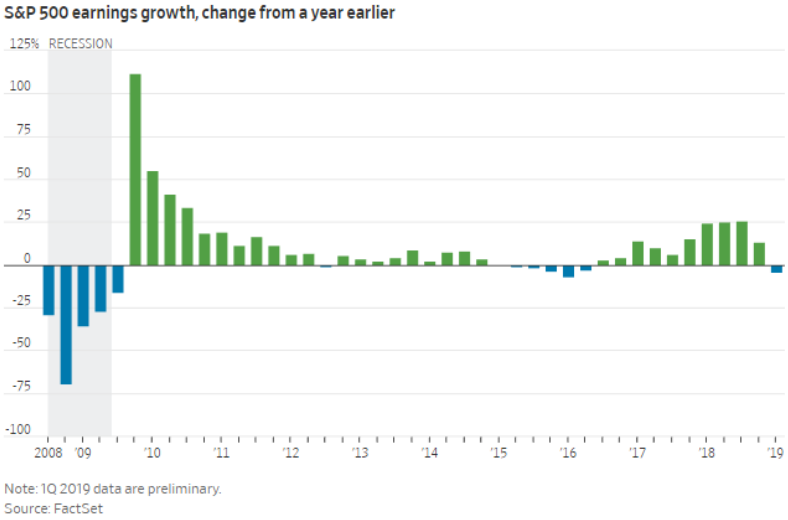
changes. Cornerstone presented the idea that perhaps these companies should have both a chief technology officer and a chief information officer, with one in charge of keeping the bank running and the other in charge of future investments to improve the bank.

Winning the war for talent. The CEOs shared stories about how they're trying to win the war for talent, with most of the challenge being around hiring the high-potential 30ish employee. Tactics will change, but the war will never end.

Seven remarkable people. One of the CEOs asked everyone in the room to describe what one event in each of our lives was the most transformational. Each one of them had a heartbreaking or inspiring story to tell. As I listened, I was impressed by what each person had overcome and accomplished, but also wished our friends in Congress could understand what decent human beings the vast majority of CEOs of banks of all sizes are.

Thanks to my friends at Cornerstone for inviting me to the session, and thanks to the seven CEOs who furthered my banking education.

A LOW BAR: Happy earnings season! For the first quarter, expectations are hardly through the roof:



The consensus believes that earnings for the S&P 500 *fell* by 2.2%, according to FactSet, which doesn't leave a whole lot of room for incremental disappointment, if you ask me. The start of an extended growth drought this is not, however, as earnings are set to resume rising later in the year:

Source: Deutsche Bank Research

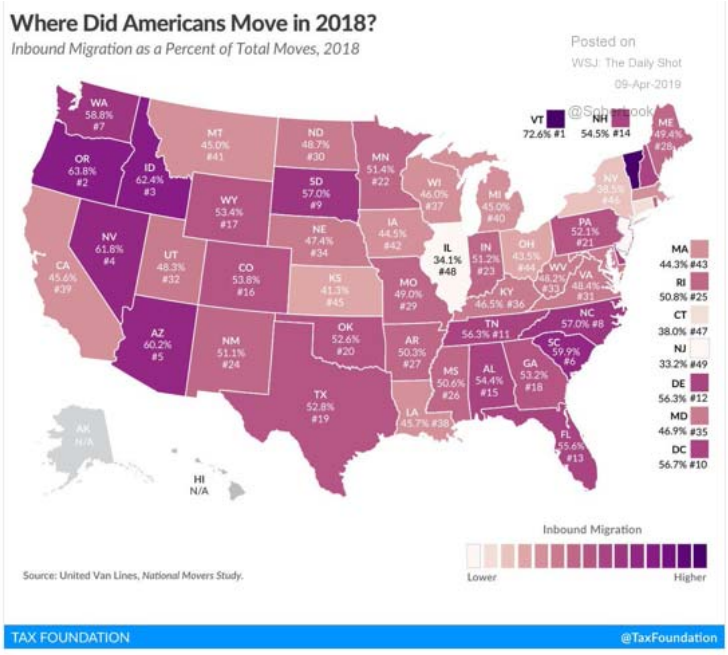
So in the near term, expectations are muted, while the outlook longer term is strong. Bullish, no?

TIMELY: While I'm on the topic, here's another reason to be positive on stocks. Money manager and columnist Ken Fisher, who seems to have made a career of unearthing nuggets like this, notes that in the third year of presidential terms, which of course 2019 is, the S&P 500 has risen 91% of the time since the index was invented in 1925, by an average of 18%. Fisher speculates that the reason stocks are so bouncy during a president's third year is that the political gridlock that tends to happen after first-term midterm elections renders the political environment highly predictable and less prone to see the passage of possibly disruptive legislation. I kind of buy that, in fact.

AVE ATQUE VALE: Retired Air Force Lt. Col. Richard E. Cole, the last surviving member of Doolittle's Raiders, the group of aviators led by Lt. Col. Jimmy Doolittle that carried out the legendary bombing raid on Japan just seven months after the attack on Pearl Harbor, passed away on Monday at the age of 103. R.I.P.

OUT THE DOOR: Talk about voting with your feet. In the year since the Supreme Court's *Janus* decision ruled that unions can't force non-members to pay partial dues, enrollment at AFSCME has fallen by 98%, while enrollment at the SEIU is off by 94%.

U.S. MIGRATION: Along that same line (kind of), Connecticut, Illinois, and New Jersey all had notably high rates of out-migration last year. The champ for in-migration, meanwhile, is Vermont, which has taken to paying people up to $10,000 to move there.



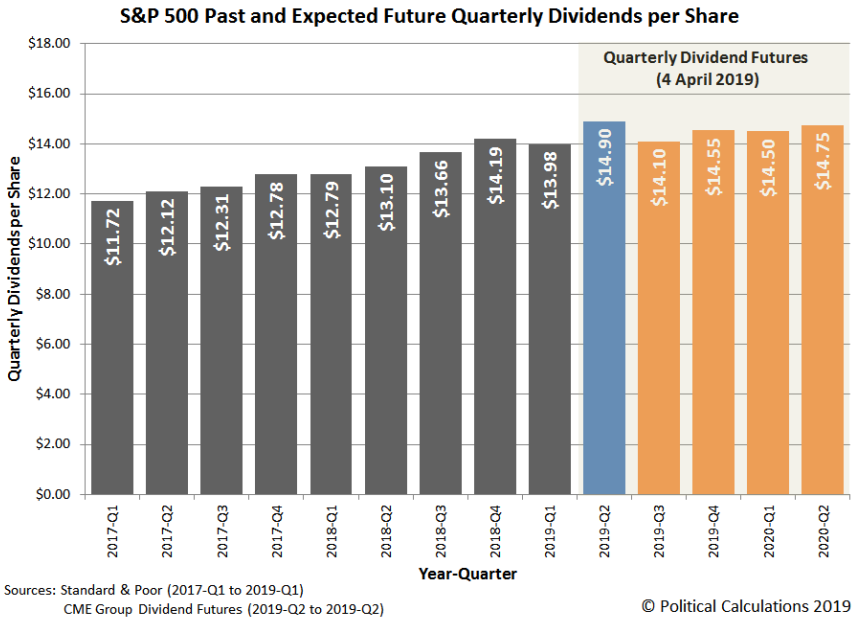
Source: @taxfoundation, @KELoughead; Read full article

BOOMING: The American fracking revolution just keeps on rolling. ExxonMobil says that it plans to reduce its all-in cost of production in the Permian Basin, now the world's largest shale field, with production nearly equal to that of Iraq, to $15 per barrel, "a level only seen in the giant oil fields of the Middle East," Bloomberg reports.

THE BENEFITS OF FRESH VIEWPOINTS: Ex-NEC head Larry Lindsey kind of has a point, I think, when he argues that the broadening of perspective that would occur at the Fed with the controversial addition there of two non-academic types, Stephen Moore and Herman Cain, would actually *enhance* the Fed's policy- and decision-making ability. Everything I've read on the topic says that groups made up of individuals of diverse intellectual backgrounds make better decisions than do less-diverse groups. (Michael Mauboussin, if you're reading this, feel free to weigh in.) Meanwhile, Lindsey notes that an all-economist lineup isn't necessarily such a great thing. "A board packed with Ph.D. economists does not guarantee a good record when it comes to economic forecasting," he notes. "Such a board definitely did not see the Great Recession happening." Hard to argue with!

A PARTIAL FIX: I know this would end up with me having to find something else to do on Saturday afternoons in the fall, but wouldn't a good first step in cleaning up some of the abuses in college admissions that were highlighted by the indictments of all those rich parents last month be to simply get rid of college sports entirely? The elimination of all those coaches would mean there'd be a lot fewer potentially bribe-able people in academia, right? Higher ed in Europe doesn't have intercollegiate sports, and seems to work just fine.

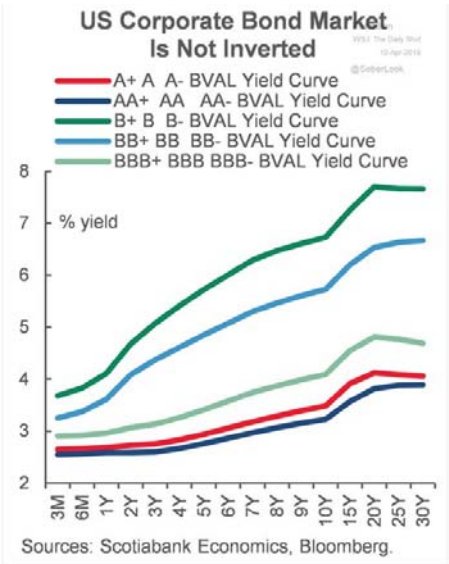
SLOWER HIKES: The CME's S&P 500 dividends futures market—which I'm chagrined to admit I didn't even know was a thing until this week—says that the rate of dividend growth for the S&P 500 will peak this quarter, then decelerate through 2020:



P.S. Hang on a minute. Why should futures on quarterly S&P 500 dividends even *exist*? A less volatile or more predictable number is hard to imagine.

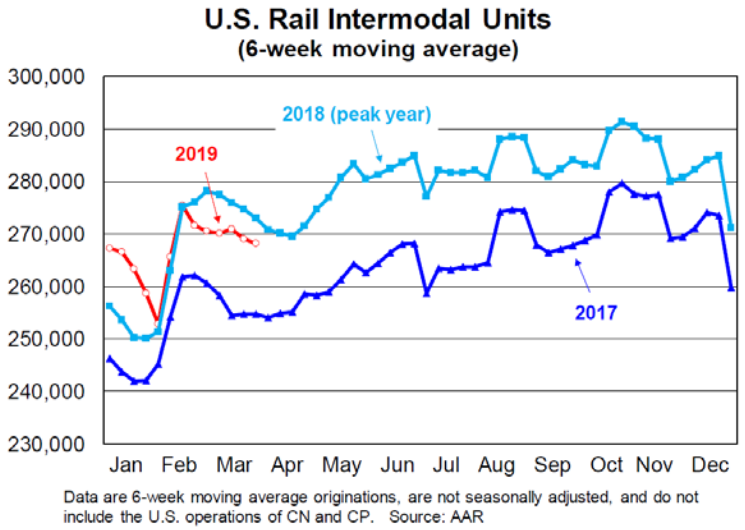
IT'S THE LAW: Whalen Global Advisors' Chris Whalen, whom I can't recall agreeing with too often over the years, makes a good point, I must admit, when he notes that the 1978 Humphrey-Hawkins legislation that established the Fed's dual mandate of promoting economic growth and maintaining price stability, specified that the Fed's inflation target should be *zero*, not the crazy 2% number that the past three Fed chairmen have weirdly insisted on clinging to.

THE RIGHT SHAPE: I hate to be a downer for all the inverted-yield-curve alarmists in the audience, but *corporate* yield curves—which are presumably much more relevant than the Treasury curve regarding the demand for and profitability of private-sector lending—are still very much upward-sloping:



Source: Scotiabank Economics

ROLLING: Slowdown? What slowdown? The Association of American Railroads reported this week that weekly average intermodal volume in March came to 266,448 units, the second-best March ever, behind only March of 2018.



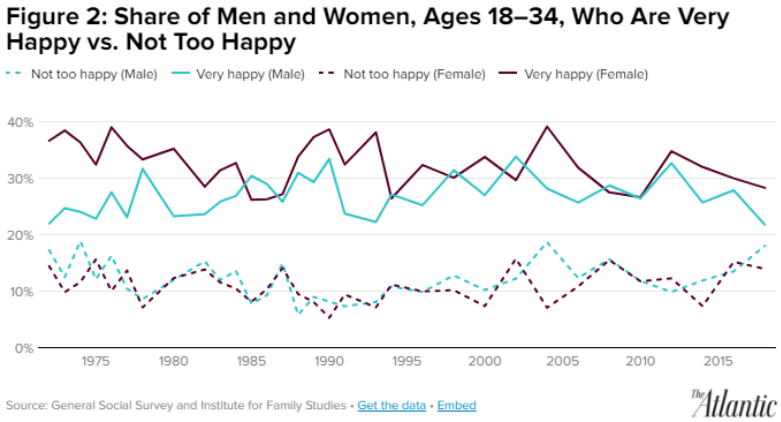
EVERGREEN: Say, here's something new and different:

Markets

Bank CEOs Should Prepare for Bashing From Congress, Analysts Say

By Felice Maranz
April 8, 2019, 11:58 AM EDT

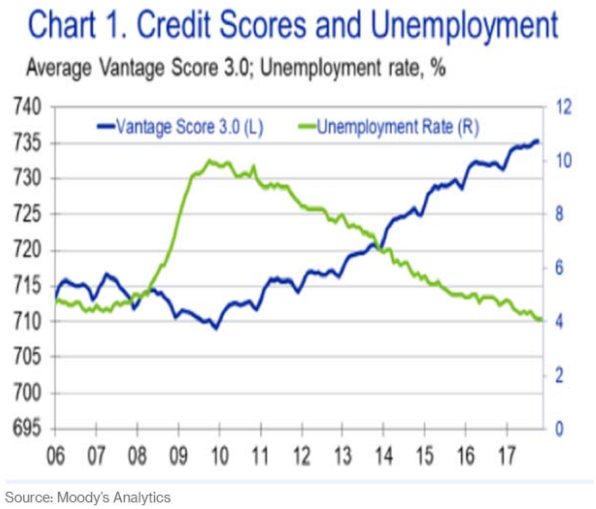
GLOOMY: More evidence society is out of whack in a very basic way: Just 22% of men aged 18 to 34 tell the General Social Survey they're "very happy," the lowest on record.



NOT SO BAD: I'm not sure I buy Goldman Sachs equity strategist David Kostin's assertion that a restriction on companies' ability to buy back their own stock, which is reportedly being considered even by some usually pro-business types in Congress, would necessarily slow E.P.S. growth and lower stock valuations, since *a*) The main alternatives to buybacks, notably dividend hikes and boosts to capital spending and R&D, would likely benefit shareholders in both the near- and long-term, which doesn't seem

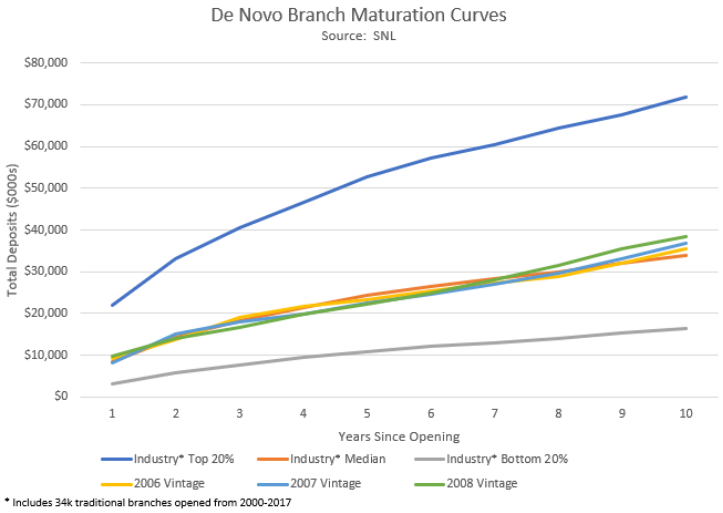
like such a bad thing for stock prices; and *b*) If the data I've seen is anything to go by, companies have as much of a tendency as everybody else to be aggressive buyers at market peaks, so that their buybacks might not always be the undiluted blessing to shareholders that the David Kostins of the world make them out to be. **Obligatory pro-buyback proviso:** Then again, *any* restriction on a management's ability to allocate shareholder capital as it sees fit is inherently a bad idea, so Kostin's basic point is sound. He's just being overly melodramatic, is all.

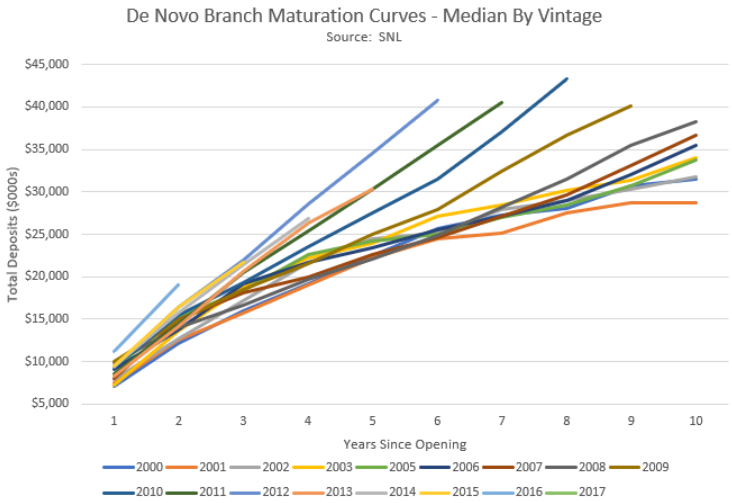
GOOD NUMBERS: As long as I'm trashing Goldman, its recent concern that, as the expansion has proceeded and unemployment fallen, credit scores have suffered from "grade inflation" and so have lost some of their ability to predict default seems a tad, shall we say, overdone, don't you think? Sure, when the next recession happens and unemployment goes up, some erstwhile prime borrowers will lose their jobs and turn out to be not so prime. That's how cycles work! Then again, the companies that compute the scores, FICO and VantageScore, have had ten more years' worth of data since the last recession to chew over (credit scores have only been around since 1989, remember) and vastly more computing power, and so have presumably used all that to improve the scores' accuracy and perhaps adjust them somewhat for cyclicality.



In any event, it's hard to believe that, as Goldman implies, the rise in the average credit score over the past decade is some sort of mirage. Memo to VantageScore CEO and loyal reader Barrett Burns: If you can provide some clarification on the issue without giving away any secrets, I'd love to hear it.

DE NOVO BRANCH VINTAGE CURVES: A hypothesis I had that bank branches that were opened around the start of the recession (that is, in 2006, 2007, and 2008) would underperform the industry average, while those opened since the recession ended would do better—my logic being that post-recession, managements would be much more judicious in picking sites—turned out to only be half true. In fact, branches opened during the recession have done as well as the industry overall, while post-recession branches have done somewhat better. Have a look:

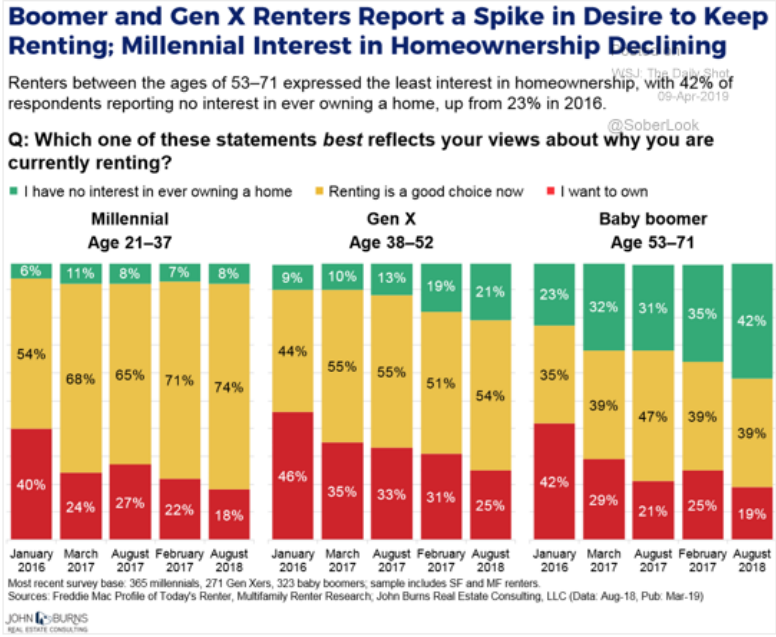




Some other notable findings:

- Prior to the recession, branches were opened in 147 MSAs, or about 38% of all metro areas, while post-recession new branches were built in just 118 MSAs, or 31% of total, reports Peak Performance Consulting Group.
- De novos opened in rural areas (that is, non MSAs) have only dropped to 22% of the total from 23%, despite the slower economic and population growth in these areas. Rural branches grow at a 25% slower pace than de novos overall.

RENTERS WANT TO STAY RENTERS: Don't ask me why, but over the past three years people say they've become less and less interested in owning their own homes:



Source: John Burns Real Estate Consulting

UNFAIR: I'm a little surprised that the anxiety that surely swept Wall Street following word of Patagonia's decision to stop making branded fleece vests for financial firms didn't cause the stock market to sink.

DISAPPEARING TRANSACTIONS: Bancography estimates that the average number of monthly transactions in bank branches fell by almost a third, to 7,200 from 11,200, between 2010 and 2016, while the total number of bank and credit union branches fell by just 4% over that same period. No one denies that a physical distribution presence is important in retail banking, but the 112,000 bank and credit union branches still open nationwide is uneconomic overkill.

RETAIL TRANSFORMATION: Even as three traditional retailers (Gap, J.C. Penney, and Victoria's Secret) are planning to close a combined 5,000 or so stores this year, three online-oriented retail startups (Casper, Glossier, and Rent the Runway) have all hit $1 billion valuations. While these new retailers conduct most of their business online, they're all also building out a small number of stores in the fanciest parts of big cities, primarily to serve as billboards. That actually doesn't sound too dissimilar to the plans Bank of America and JPMorgan Chase have for entering new markets.

SHOCKING PREDICTION: The number of single-person households worldwide will jump by 128% between 2016 and 2030, Euromonitor International predicts, with the rise driven by a 79% iuncrease in the number of divorces around the world over that period. The researchers expect the trend to create an apartment boom, particularly micro apartments, in big cities like New York, London, and Tokyo.

THE CONFUSED CONSUMER: Consumers might say they're worried about data privacy, but they don't seem to be taking a lot of action to do anything about it. PwC reports that while 92% of consumers say they should be able to control the information about them on the internet, a survey by IBM showed that just 45% have actually updated their privacy settings, and only 18% have deleted a social media account.

WHERE IS THE ENFORCEMENT?: What's happened to the Do Not Call List that was designed to prevent unwanted phone solicitations? The FCC has collected just $6,790 of the $208 million in fines it has levied for DNC violations since 2015. The FTC, meanwhile, has collected only $121 million of the $1.5 billion in fines it's imposed since 2004.

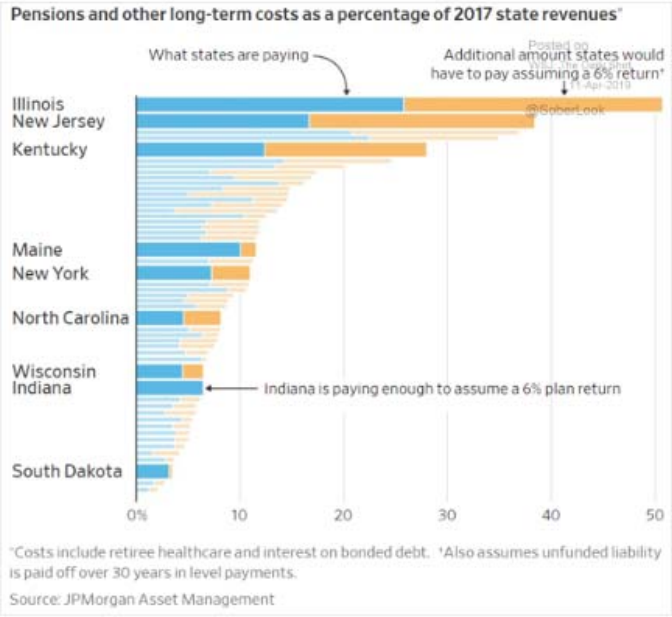
TEMPORARY EMPLOYMENT: NASA and the European Space Agency are looking for volunteers to spend two months in bed as part of a study they're doing on the effects of weightlessness. Participants in the "Artificial Gravity Bed Rest Study" (AGBRESA) will be paid $19,000.

THE SWISS DOWNGRADE COFFEE: The Swiss drink twice as much coffee per capita as Americans do, if you can believe it, and were concerned enough about maintaining access to it that, following World War I, they even set up an emergency coffee stockpile. No more. The government is winding down its stockpile, and says that "The Federal Office for National Economic Supply has concluded coffee . . . is not essential for life. . . . Coffee has almost no calories and subsequently does not contribute . . . to safeguarding nutrition." Crazy talk, if you ask me.

QUICK TAKEOFF: Believe it or not, but early growth in micromobility, made possible by companies like Lime and Bird, has been even more dramatic than the early growth of Uber and Lyft.

Source: Barclays Research

PENSION ASSUMPTIONS: Many states' pensions are of course wildly underfunded—even as the states use assumptions for investment returns that are way too optimistic. It's nuts. Here's each state's obligation assuming a more realistic 6% return on investments:



Source: @WSJ; Read full article

Only Indiana currently uses an assumed rate of return of 6%.

NEXT WEEK: A couple of housing-related releases next week will bear watching. First, on Tuesday, we'll get the National Association of Homebuilders' **Builder Confidence Survey** for April. The consensus expectation is 64 vs 62 in March. Then on Friday, March **Housing Starts** will come out. The consensus looks for 1.230 million units, annualized and seasonally adjusted, vs 1.162 million in February. Also of interest next week: March **Leading Indicators**, out Thursday. The consensus expects a monthly change of +0.4% vs +0.2% in February.

THE LAST WORD: As our systems at Second Curve have moved to the cloud, we've had to beef up their security by adopting "dual authentication" and moving to the practice of changing our passwords every 90 days. What a nightmare. I had to change my password yesterday, and in the process found out that I have access to our system via nine separate devices, including PCs in multiple locations, iPads, and smartphones, all of which require their own password change. I ended up spending 20 minutes on the phone with our IT guy, who walked through the process. When I was done I was both relieved that everything is secure, but also fearful that I have to repeat the process in just 90 days. I know how important authentication is, but could someone please make it easier for me.

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