

Robert Albertson | Chief Strategist, MD  
212-466-7946  
robert.albertson@psc.com

Weison Ding | Director  
212-466-8005  
weison.ding@psc.com

## A COMPLICATED 2022

- **Economy Deceleration**
- **Loan Growth Rebound**
- **Rising Rates**
- **Technology Differentiation**

**Summary:** *The outlook for financials in 2022 is more complex than usual. While the likelihood of rising short term interest rates are a powerful positive for bank earnings and loan growth appears to be in recovery, the overall economy is set to decelerate to somewhere in the 2% growth vicinity toward the end of the year as effect from government spending impact during the recovery now wanes. This could presumably weigh on loan growth, leaving higher interest rates the primary driver for bank earnings.*

*Additionally, headline earnings results will suffer from the unusually large loss reserve releases during 2021 resulting in negative year-over-year comparisons. Only pretax, pre-provision earnings will better reflect underlying growth. Finally, the regulatory environment will remain hostage to political winds until the mid-term elections. We believe the prospect for higher rates should be sufficient for a decent year but other factors bear watching as the year unfolds. These are competing variables. We are still recommending an overweight position for financials.*

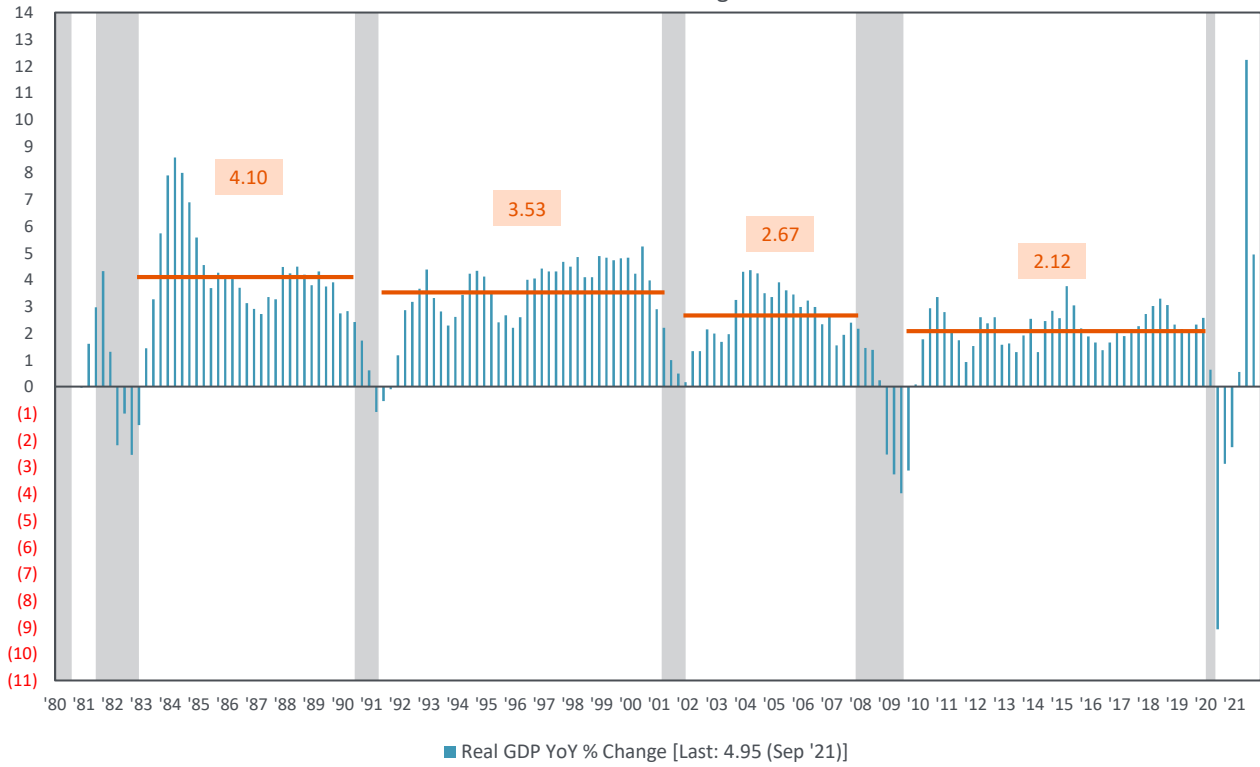
*Our Research Department has modeled core bank EPS down 10% for 2022 following a breathtaking 47% rise in 2021 with a solid 8% rise expected in 2023. The results for 2021 included major one-time gains from loss reserve releases, PPP fees and strong mortgage revenues, all of which will be missing in 2022. Pre-tax, Pre-provision Net Revenue is estimated off 1% for 2022 following an 8% rise in 2021 but with a 10% gain in 2023. Results could prove better assuming short rates rise.*

---

**Economy Decelerating:** As COVID stimulus programs ebb the economy will transition from recovery to trendline growth, which we and others recognize as 2% or less. The case for this trendline degradation can be seen from the following three exhibits. First is a graph of average GDP growth in between recessions showing a steady weakening following the last three downturns, from 4.1% core momentum in the 1980s to 3.5%, to 2.7% to 2.1% following the Financial Crisis to something potentially under 2% going forward, which is reflected in many economists' projections for 1.7-1.8% growth in 2023.

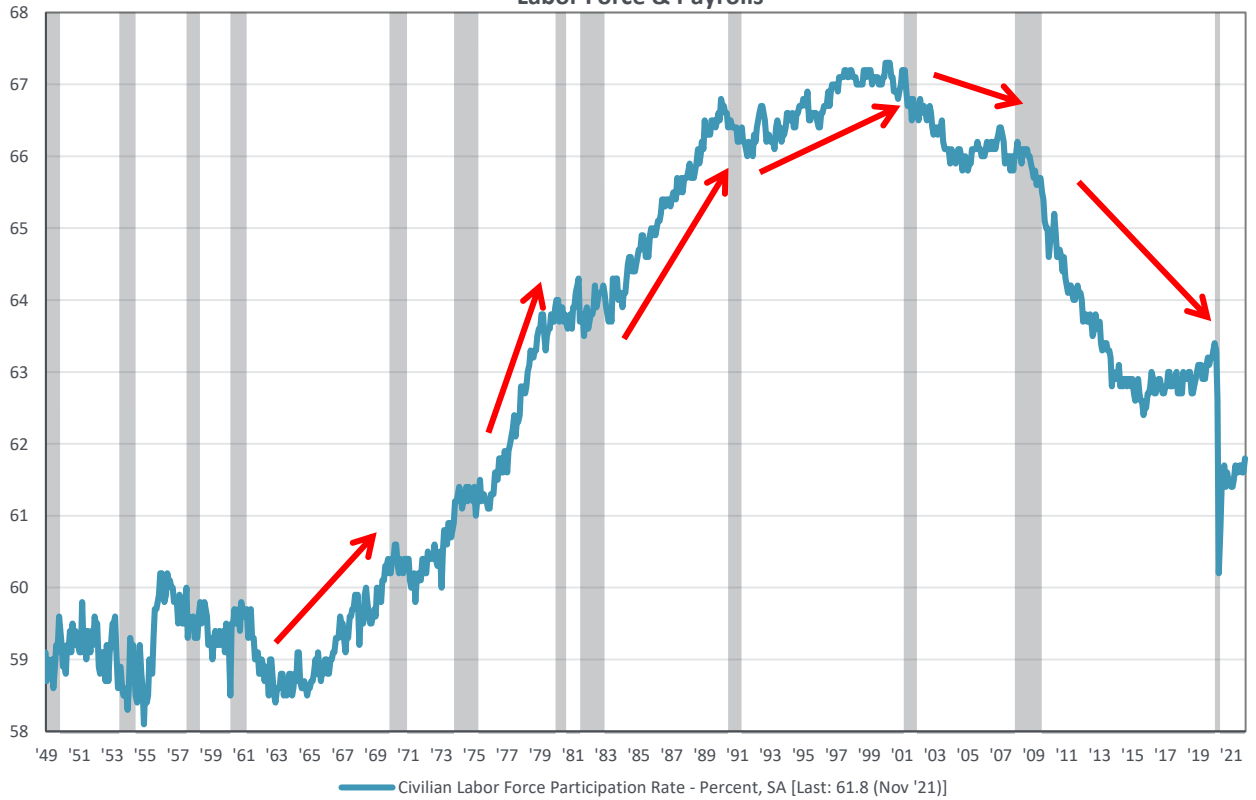
The genesis for this downshifting is primarily demographics and another indication of this is found in the second exhibit depicting labor participation rate faltering after 1990, now settling below 62%, a level not seen since the late 1970s. The third exhibit illustrates payroll growth on a log scale which broke trend twenty years ago, only partially recovering momentum through the present and falling an incredible 55 million jobs below where the previous trendline would have taken us. The damage to our economic momentum has been stark.

### US GDP Growth Real YoY % Change



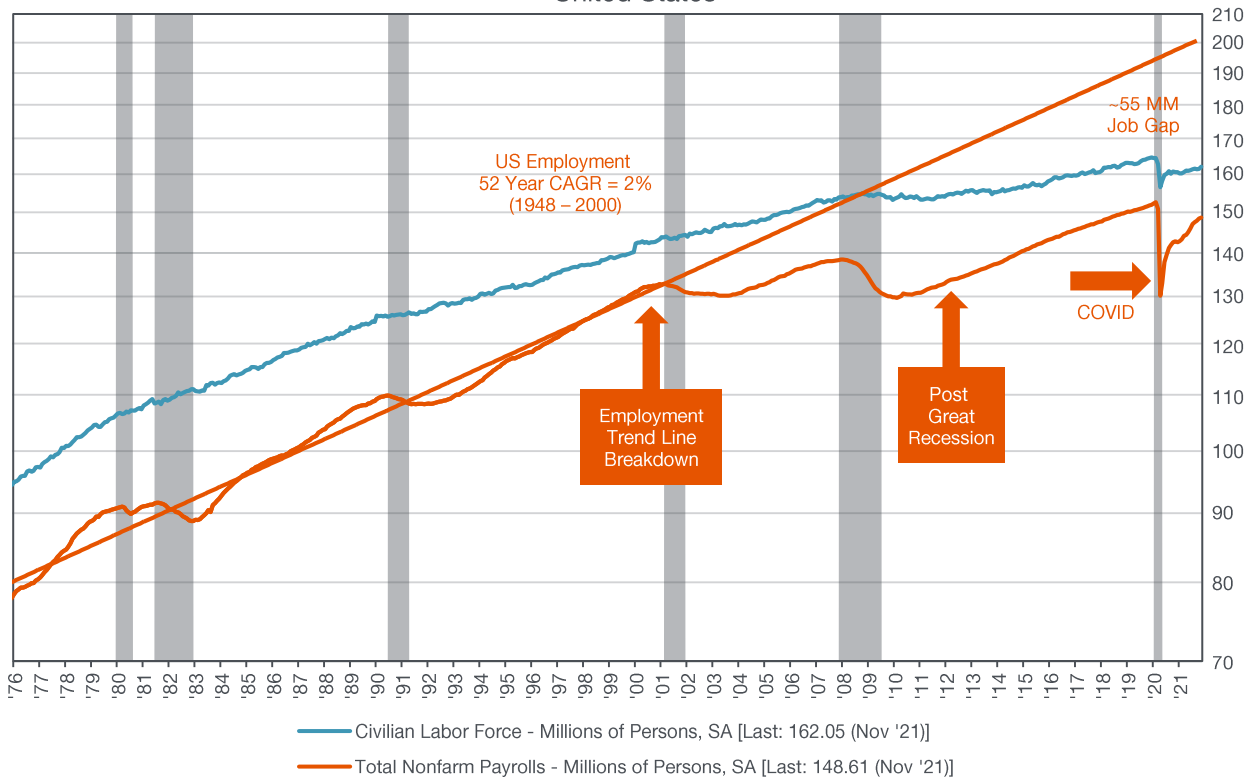
Source: Bureau of Economic Analysis

### Labor Force & Payrolls



Source: Bureau of Labor Statistics

### Labor Force & Payrolls (Log Scale) United States

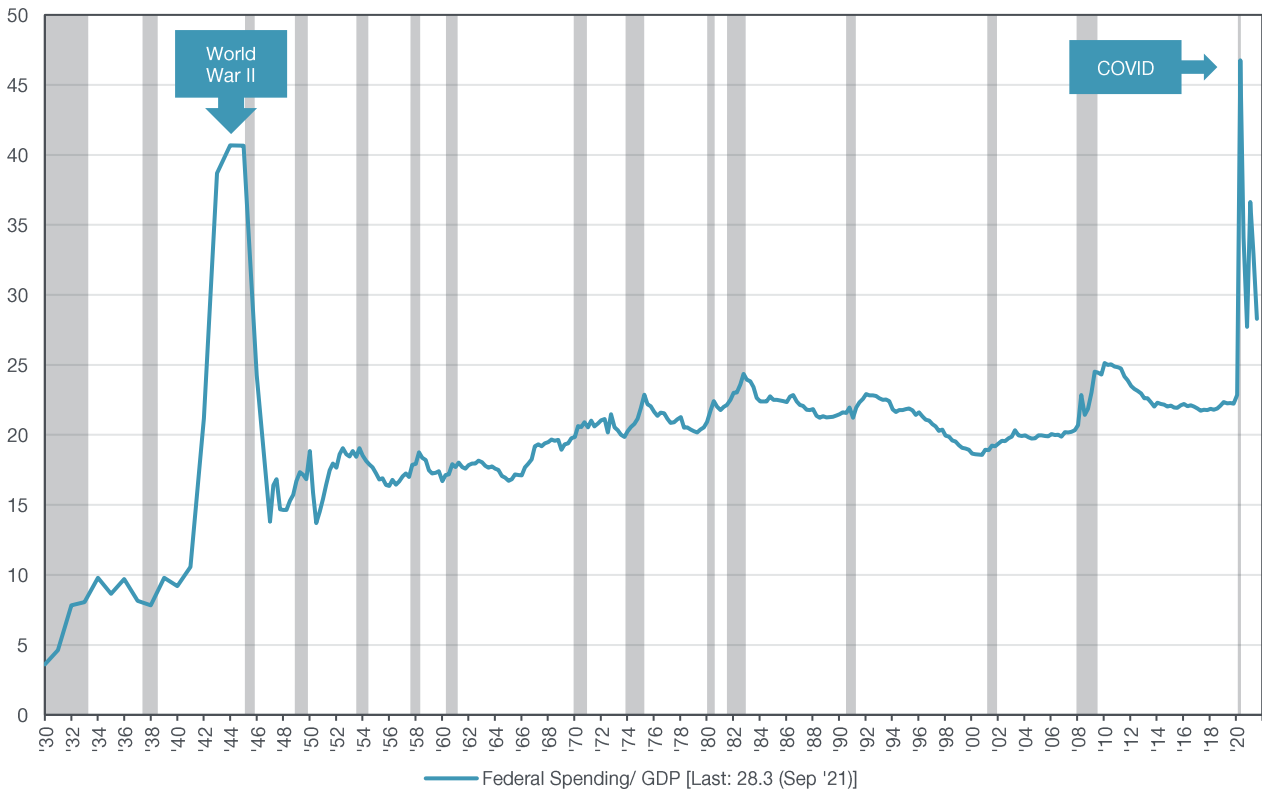


Source: Bureau of Labor Statistics

On a quarterly basis, following only 2.3% GDP growth in the third quarter, estimates for the fourth and first quarters have come down reflecting the explosion of Omicron cases. After a presumed recovery in the second quarter, 2022 is estimated at 4%+ but by yearend GDP growth should fall to the 2% trendline vicinity with further slowing probable in 2023.

A 2% or less growth trendline is generally accepted for the near term but the above graphs add certainty to this outlook. Without the stalled Build Back Better package there is little to expect a better result. Even with the \$2 trillion original BBB the impact on GDP growth would have been somewhat marginal. Assuming the 10-year life span it would have averaged a nominal \$200 billion annually in gross addition to government spending, ignoring negative impacts from higher taxes, etc. The gross impact on GDP would have been 0.9% and more like 0.7% on 2023 GDP.

### Federal Spending to GDP (%)



Source: OMB, Bureau of Economic Analysis

Put in perspective, government spending peaked at 45% during the pandemic, higher than experienced even during WWII and well above the 22-23% average over the previous decade! See above. All said, on a net basis GDP might reach 2.5% per annum on the near term at best with a BBB revival. Ultimate passage of BBB, if it occurs, would be more in the range of \$1.5 trillion in our view. In sum the general economy alone will likely no longer be a substantial wind at the back for financials.

**Loan Growth:** Excepting the Paycheck Protection Program (PPP), loan growth was anemic throughout the pandemic. However, organic demand, excluding PPP, began a revival in the second quarter of 2021 and many banks reported low double-digit annualized loan growth for the third quarter! Including PPP, third quarter annualized loan growth was 3% accelerating to 9% during the fourth quarter. We estimate fourth quarter loan growth could again be low double-digits for many banks excluding PPP. However you cut it loan momentum appears to be back. Our Research Department is conservatively modeling just under 4% growth in 2022, rising to 7% in 2023.

Importantly, loan growth at the regional and community bank level has, for the tenth year in a row, exceeded that of the largest banks. The exhibit below depicts loan growth at banks above and below roughly \$100 billion in assets. The data spike for both beginning in 2020 was driven by PPP loans. Notwithstanding this, banks below \$100 billion continued to best the largest banks by an ample margin over time, indicating they have become more relevant in the intermediation process.

### Loans at Domestically Chartered Banks YoY % Change

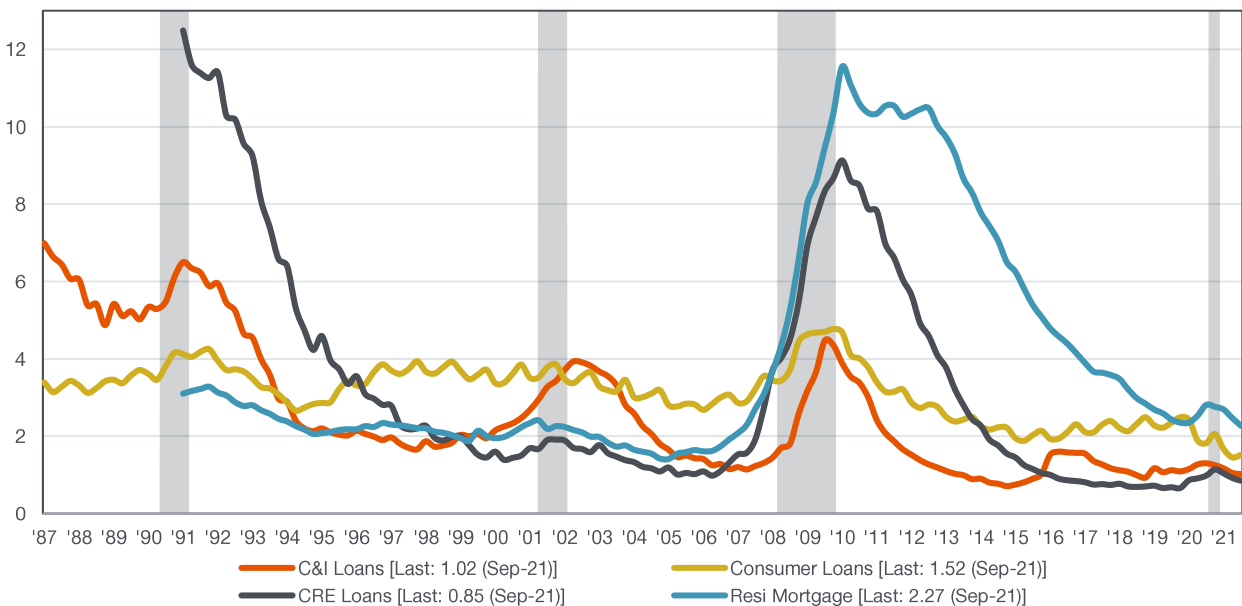


Source: Federal Reserve H8 Series

The quality of lending held together quite well through the pandemic, despite an unprecedented economic shutdown! At the outset banks were not at all certain of this and raised considerable loss reserves. The Fed's DFAST 2020 stress test referenced potential cumulative losses ranging from 820bp to 1030bp. Reality proved nothing even remotely close to this level of damage, and banks began releasing reserves in 2021. In retrospect loss expectations proved ridiculous, although at the time sentiment was extremely negative. No one knew what a protracted, closed economy would do to bank credit.

The pattern of delinquencies across all four major categories is nothing less than remarkable. Only residential mortgages and commercial real estate had barely perceptible "blips" during 2020 and three categories have returned to pre-Covid levels, while consumer delinquencies are at an all-time low. Net chargeoffs were a minimal 17 basis points in 2020, and 2021 had net recoveries. Some modest rise in chargeoffs is to be expected in 2022 reflecting more normal conditions.

### Delinquency Rates: All Commercial Banks (%)



Source: Federal Reserve

**Rising Interest Rates:** The highly likely keynote for banks in 2022 will be rising short term rates. Without necessarily retreating from their “transitory” stance on inflation, the Fed appears likely to begin raising the Policy Rate somewhere in the first quarter and the consensus now seems to be three hikes during the year. We think it can be more, with further increase probable in 2023. It is our view that, sometime in 2023, the Effective Fed Funds Rate will breach 2%, and even possibly 3%, as the Fed removes unnecessary stimulus and heads towards a more normal or “neutral” rate band. This will be the primary driver for bank stocks in the near future, although second-guessing the targeted level will consume endless speculation.

Whether inflation is transitory or not, it will not be transitory enough to allow the Fed to leave rates at the bottom. There are cogent, articulate arguments being made on both sides of the longer term inflation outlook, and we will gather evidence one way or the other during 2022. The labor force is extremely tight based on JOLTS and hourly earnings data as well as an abysmal 61.9% participation rate (see above) through December and an average 61.7% for the year. After peaking near 15% the unemployment rate fell to 3.9% in December. Monthly job growth averaged 543,000 for 2021 while the labor force average monthly gain was only 135,000. This argues for more inflation.

To be sure there are elements contributing to inflation that are likely to lessen or correct, such as supply shortages aggravated by shipping logjams during the holidays. Other elements may prove stickier, such as energy costs. As the world marches on toward green energy, the closure of nuclear power plants from Germany to California augur troublesomely for energy costs. Commodity prices are another, potentially stickier contributor to inflation as politically-driven tariffs are imposed for steel and other products. Perhaps labor costs are the area to watch most closely as inflation has a well-known psychological component. If people remain concerned about inflation they tend to demand higher wages to motivate spending. Inflation can easily become a self-fulfilling phenomenon based on perceptions, as it did beginning in the late 1970s. Average hourly earnings already averaged 4.9% growth in the fourth quarter.

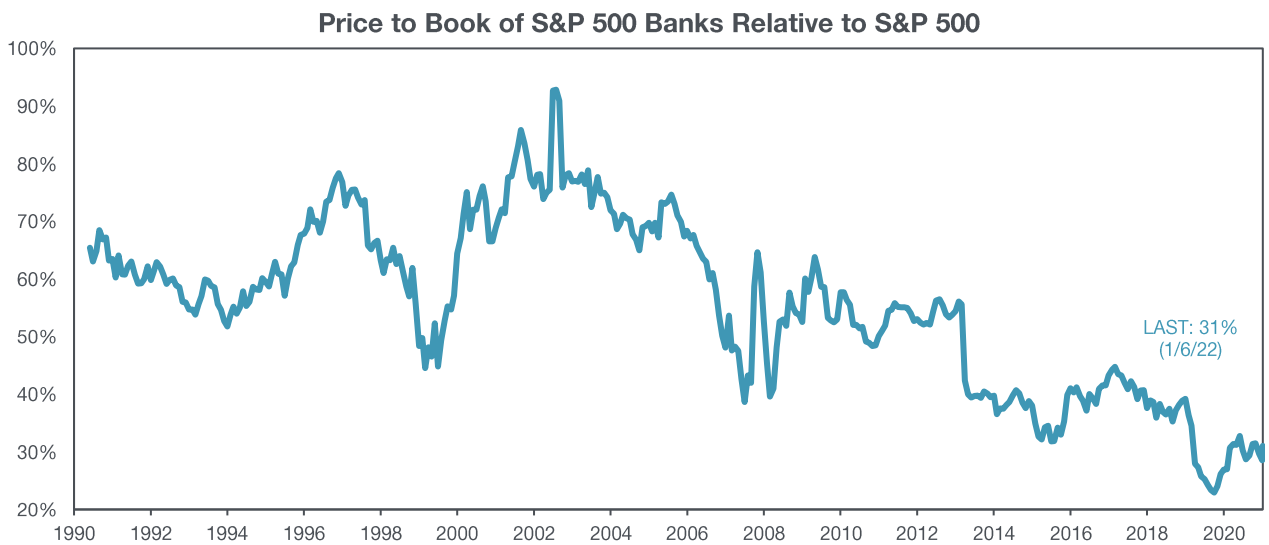
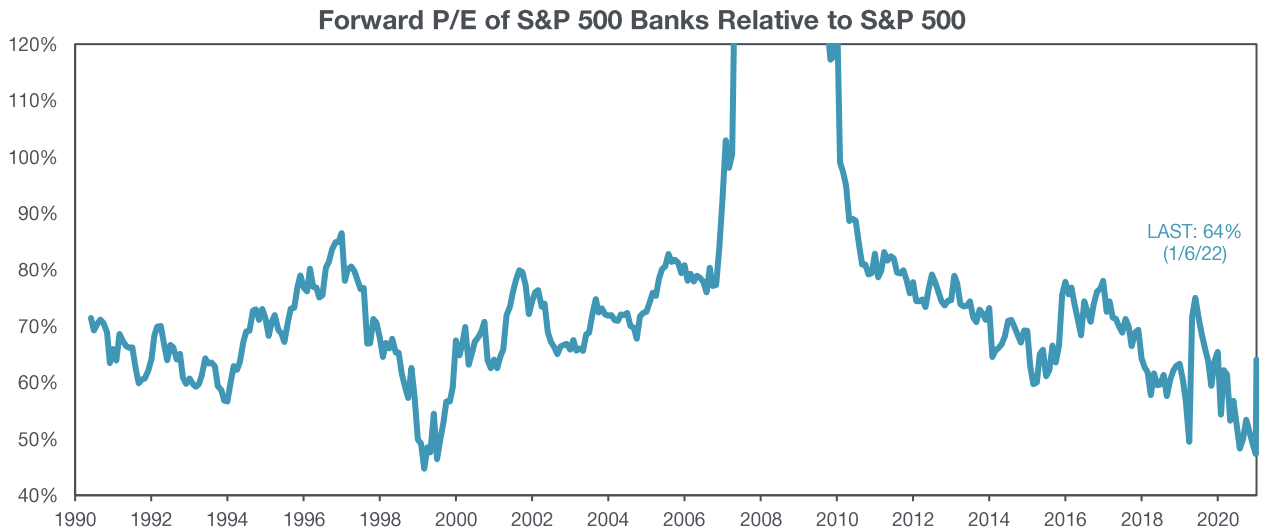
Further flattening of the yield curve is likely as short rates begin to rise while long rates lag. Long rates are primarily influenced by two factors, the outlook for inflation and the expected average level of Fed Funds plus a term premium. While flattening hurts the investment portfolio net yield as it is invested long and funded short, the reverse is true for the loan portfolio which is lent short and funded long. As the loan portfolio is much larger and the yields much higher, rising short rates are an overall positive on a consolidated basis. Banks are almost universally asset sensitive. Simply put, rising short rates trump a flatter yield curve. Moreover, the Fed could ultimately begin selling its holdings in Treasuries and MBS, which would eventually elevate longer term interest rates.

However, expectations for net interest margin improvement will be somewhat delayed by interest rate floors on loans. This would push back any substantive positive into late 2022 and 2023. The stocks would likely discount this benefit well ahead of actual margin expansion, and already have.

**Technology Differentiation:** The year 2022 should show bottom line and return on capital improvement from the implementation of a multitude of Fin-Tech platforms and provide an edge for those seeking market share gains. The level of Fin-Tech investing was increasingly noticeable in 2021 earnings calls as banks reflected higher technology expense and disclosure of some of these new platforms.

Broadly-speaking they are productivity drivers and enhance customer experience. Two categories in particular are potentially transformational: Conversion to cloud-native, API-first (Generation 3) core operating systems and application of the Blockchain. Both first appeared among only a handful of banks in 2021, and we expect proliferation to begin in 2022. A Generation 3 core system not only offers a productivity advantage but more importantly a marketing platform that matches challenger and neobank competition. Blockchain can enable stablecoin transactions, accelerate mortgage business, generate deposit partnerships, modernize payments, and reduce capital requirements. Look for more early adopters in 2022 that will positively differentiate results from Fin-Tech.

**Undervaluations Persist:** Despite their dramatic outperformance in 2021, bank stocks still trade at low valuations relative to the market. Assuming short rates rise, considerable upside remains. Forward price/earnings for the group is barely at 50% of the S&P 500, nearing its 1999 nadir. Relative book value for the group is at an historical low of about 30% that of the S&P 500 versus an historical average of 70%.



Source: Bloomberg

**Risks and Conclusion:** Two obvious risks are either a delay or limitation to rising interest rates on the one hand, or the rise in rates spurring a further deceleration in economic growth. These risks appear likely remote in our view, although economic momentum could be reduced pending the speed and level of short rates. The Fed certainly recognizes this. Another possible risk is the negative impact of higher rates on equity valuations generally. Cyclical stocks should continue to fare best.

Bottom line, rising short term rates should still be an exceptional positive for bank stocks and we remain overweight.

## General Information and Disclaimers

This report has been prepared and issued by Piper Sandler & Co., a registered broker-dealer and a member of the Financial Industry Regulatory Authority, Inc. The information contained in this report (except information regarding Piper Sandler & Co. and its affiliates) was obtained from various sources that we believe to be reliable, but we do not guarantee its accuracy or completeness. Additional information is available upon request. The information and opinions contained in this report speak only as of the date of this report and are subject to change without notice. Contact information for Piper Sandler & Co. and the author of this report is available at [www.PiperSandler.com](http://www.PiperSandler.com)

This report has been prepared and circulated for general information only and presents the author's views of general market and economic conditions and specific industries and/or sectors. This report is not intended to and does not provide a recommendation with respect to any security. This report does not take into account the financial position or particular needs or investment objectives of any individual or entity. The investment strategies, if any, discussed in this report may not be suitable for all investors. Investors must make their own determinations of the appropriateness of an investment strategy and an investment in any particular securities based upon the legal, tax and accounting considerations applicable to such investors and their own investment objective. Investors are cautioned that statements regarding future prospects may not be realized and that past performance is not necessarily indicative of future performance.

This report does not constitute an offer, or a solicitation of an offer, to buy or sell any securities or other financial instruments, including any securities mentioned in this report. Nothing in this report constitutes or should be construed to be accounting, tax, investment or legal advice.

Neither this report, nor any portion thereof, may be reproduced or redistributed by any person for any purpose without the written consent of Piper Sandler & Co.

© 2022 Piper Sandler & Co. All rights reserved.