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Upside in 2018

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- **Economy Remarkably Immune to Political Uncertainty**
  … Jobs Growth Trend of 1.5% Persists
- **Probable Revival in Business Spending**
  … Early Signs of Fixed Investment Growth
  … Tax "Reform" an Additional Positive
- **Bank Margins Likely to Exceed Expectations**
  … Fed Rate Hikes More Certain
  … Yield Curve Worries Overdone
  … Loan Yield "Betas" Getting Ahead of Deposit Betas

Our Insulated Economy: Amazingly, nothing has changed! This has been demonstrably true in the broad U.S. macroeconomic portrait for over a year. This is despite wrenching shocks that include record weather-related damages, untethered politics, interest rate hikes and rampant global populism.

Obsession with monthly employment data, for example, has yielded little directional change. "Jobs Friday" releases consistently revert to a strikingly rigid trajectory despite monthly variance. The jobs data has remained remarkably stable on a six-month, one-year and year-to-date basis. Even the hurricane distortion is largely erased using these averages including November.

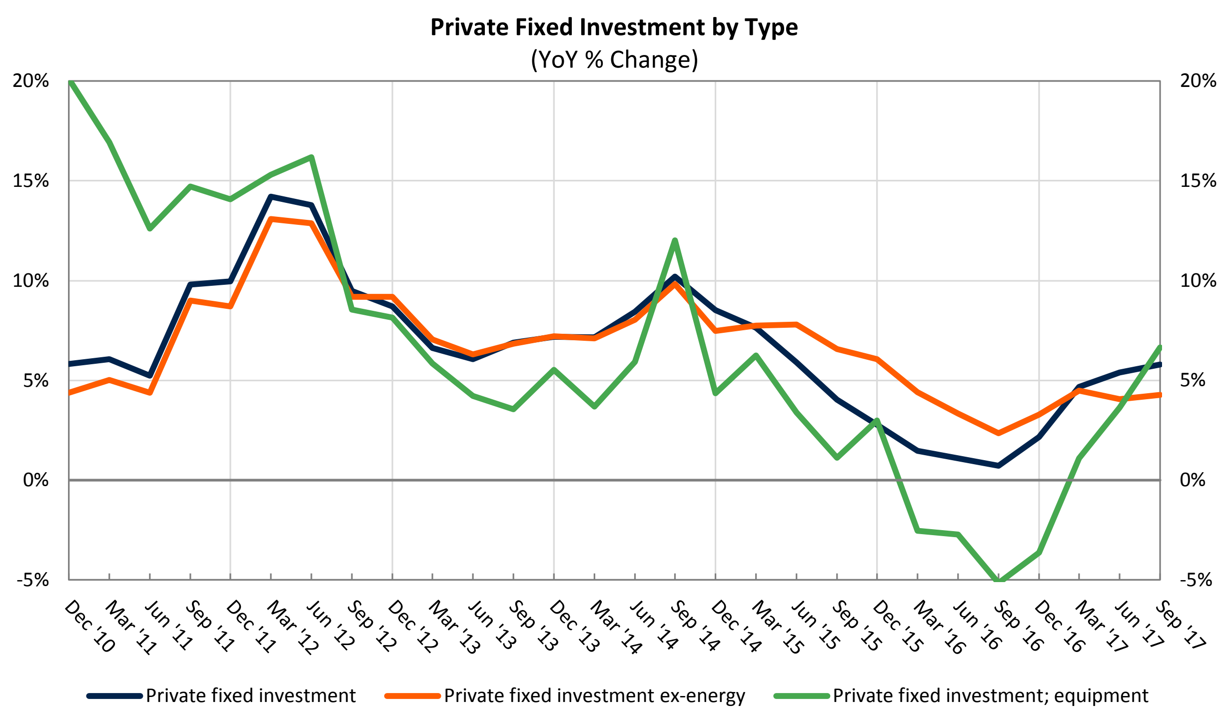
Jobs are up within a tight range of 1.4% to 1.5% year over year across all three of these averages. Employment growth remains almost exactly double the labor force growth, which has been growing within a tight range of 0.7% to 0.8%. This seemingly unshakeable relationship virtually assures further decline in the unemployment rate.

The same stability is visible in the labor force participation rate as well as the employment-population ratio, at 62.9% and 60.1% respectively, both within minimal variance of 2/10ths of 1% across these same three averages. Demographics continue to dominate and restrain job growth but the employment trajectory has not changed, nor has wage growth at 2.6% across all three of these averages.

Consequently, we see no reason to change our slower-but-longer economic cycle backdrop for financials into 2018. While this trend line stasis will eventually end, there is only reason to expect marginal improvement rather than any diminution in the short run. Benefit from lower tax rates should stimulate both consumer and business spending and borrowing to some extent, in 2018, although it is too early to quantify. We also see bank net interest margins exceeding investor expectations in 2018, discussed below.

Much Needed Business Spending Revival: While steadily growing employment certainly favors the two-thirds of the U.S. economy that is consumer driven, the same hasn't been seen in data from the much smaller commercial sector. Business spending as reflected in fixed investment data has been consistently moribund and disappointing since 2015, but an upturn finally appears in place. While much smaller in GDP terms, business spending is critically important in sustaining steady, longer-term employment growth.

A nascent recovery can be seen emerging over the last few quarters. Still modest and still partly energy-related rebound, it provides reason to be more optimistic. The following exhibit illustrates the rapid decline in private fixed investment (PFI) from a 10% year-over-year pace in 2014 to a virtual standstill by late 2016 after approaching a $3 trillion annual pace, markedly influenced by the oil price decline in the energy sector. This pace rebounded to almost 6% over the last year, including material new momentum from non-energy spending as depicted in red.



Source: Bureau of Economic Analysis, Sandler O'Neill

Direct energy exploration in context of size expanded by $43 billion over the last four quarters, while all other non-residential spending advanced by $133 billion. Spending on equipment, a third of PFI, has had a rather dramatic revival off its year ago bottom, expanding by almost $70 billion. Residential construction momentum continues with a $36 billion advance in residential construction.

How much of this business spending recovery can be attributed to tax reform expectations cannot be known, but the mere fact that corporate tax cuts are now certain can only embolden this rebound in fixed investment. In turn, this should amplify business borrowings. How much remains to be seen, but the delta is up, not down.

Latency in Net Interest Revenues: Another underestimated positive for financials lurks inside the basic banking engine. **<u>Analysts have consistently and materially underestimated net interest margin upside during this rising (we prefer to call it normalizing) interest rate environment.</u>** We believe net interest margin outperformance will continue exceeding investor expectations in 2018. At the moment investors and analysts appear distracted over a flattening yield curve rather than measuring further upside from rising interest rates. This is particularly key to loan repricing, which has gotten little attention so far.

The yield curve concern is a somewhat illogical, as (1) bank loan portfolios trump securities portfolios in terms of both size and interest spread. While loan yields have certainly lost some of their premium over securities yields, both are nevertheless rising.

Just as important, (2) loans tend to be funded longer and securities tend to be funded shorter relative to each other. This is not widely understood. Whenever the yield curve compresses securities portfolios clearly suffer. But loan portfolio spreads tend to rise with short term interest rates. Oversimplifying, banks fund short to invest long but most fund long to lend short, particularly those banks with a high proportion of rate sensitive commercial loans. Said another way, the short end of the yield curve tends to dominate variable rate loan pricing.

Additionally, (3) securities holdings outside the largest institutions have declined relative to total bank "credit" (loans plus securities). While securities at the top 25 domestic banks have risen from 28.7% to 30.6% of bank credit over the last five years, those under the top 25 (approximately 800 in the Fed H.8 data series with assets below approximately $50 billion) have seen their securities decline from 25.3% to 21.5% of total bank credit.

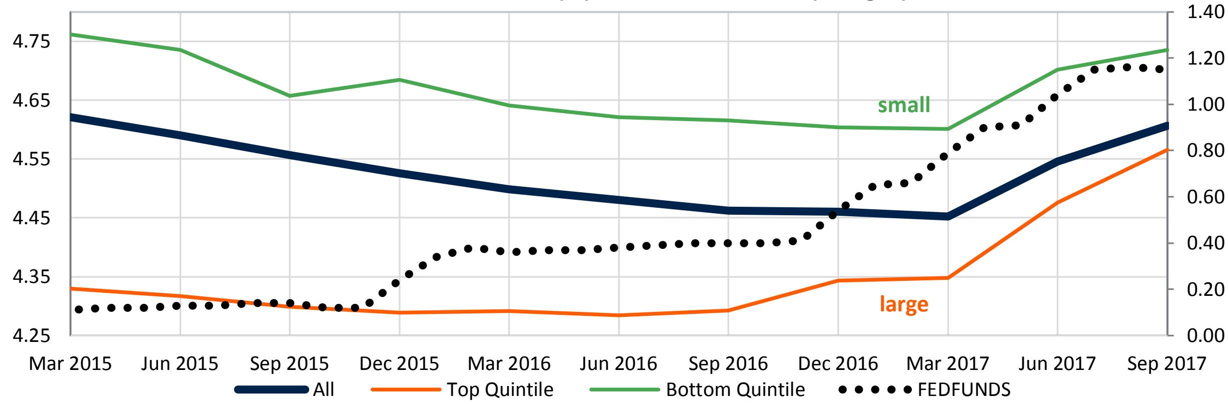
Finally, (4) the yield curve should eventually self-correct from any inflation-based paradigm change. In simpler words, if core inflation reaches or surpasses the current 2% target, the long end of the yield curve should react sufficiently to reflect that. If core inflation were to weaken, the Fed would likely put Policy rate hikes on hold, containing the short end of the yield curve.

Bank earnings are therefore likely to exceed expectations in 2018 primarily due to unrecognized rate latency in net interest margins. Investors have had deposit rate "beta" (relative responsiveness) on their minds ever since the Fed began hiking rates in late 2015. But loan rate beta must also be taken into account, in context with other factors such as a bank's size or loan mix. Bank net earnings have only moderately exceeded expectations since rates began to rise. Many other factors were responsible. Loan growth fell short of expectations, a critical fundamental blunting much of the margin benefit. However, remaining net interest margin expansion embedded in lending should further drive 2018 net earnings above expectations. A helpful way to understand net interest margin latency is to examine beta dynamics in both gross loan yields and total deposit costs as the Fed Funds rate began rising after seven years at their record bottom. We now have seven quarters of data since the Fed began normalizing the Policy rate, giving ample time to reflect rising short rates on both deposits and loans.

The following exhibit examines actual loan yields and deposit costs for 234 banks between $2 billion and $500 billion in assets. We excluded trust banks as well as banks above $500 billion in assets from our data universe to help limit influence from capital markets and international activities. The exhibit below includes top and bottom quintile averages by asset size. The top quintile's mean size was $73 billion and the bottom quintile's mean size was $2.5 billion.

Sensitivity to Fed Rate Hikes – by Asset Size

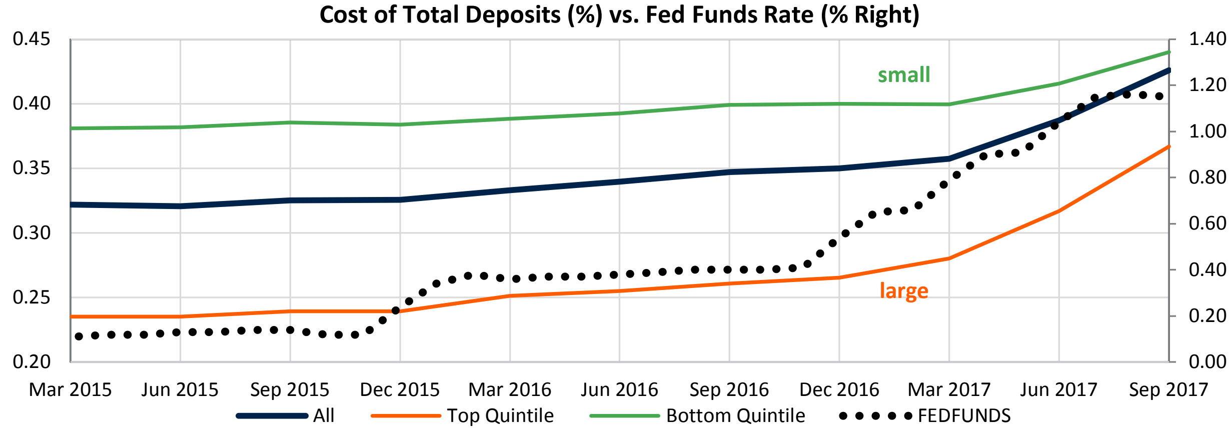
Yield on Total Loans (%) vs. Fed Funds Rate (% Right)



Change in..	2016	"Beta"	2017 YTD	"Beta"	Overall	"Beta"
Fed Funds (bps)	**25***		**75****		**100**	
Loan Yields (bps)	**(7)**	**(26%)**	**15**	**19%**	**8**	**8%**
Large	**5**	**22%**	**22**	**30%**	**28**	**28%**
Small	**(8)**	**(32%)**	**13**	**17%**	**5**	**5%**
Deposit Costs (bps)	**2**	**10%**	**8**	**10%**	**10**	**10%**
large	**3**	**10%**	**10**	**14%**	**13**	**13%**
small	**2**	**7%**	**4**	**5%**	**6**	**6%**

* Includes Dec 2015 hike ** Includes Dec 2016 hike and two hikes in 2017

Cost of Total Deposits (%) vs. Fed Funds Rate (% Right)



Source: SNL Financial, Sandler O'Neill

We show two periods based on data beginning after the first rate hike in December 2015 as it impacted 2016 and then the three following hikes from December 2016, March 2017 and June 2017 as it impacted 2017 through the third quarter. We should learn even more after fourth quarter results are in.

Loan yields remained in decline through most of 2016 but very clearly accelerated faster than deposit costs during 2017. Loan yields averaged a 19% beta during the first nine months of 2017 while deposit betas averaged only 10%. Interest rate floors, declining net interest accretion from acquisitions and fixed rate lending in general were presumable causes for the delayed loan yield reaction. Large banks in the top quintile by asset size carried a 30% loan beta against a 14% deposit beta during 2017. Small banks in the bottom size quintile carried a 17% loan beta against a 5% deposit beta in 2017 following a significant negative loan beta in 2016.

Going forward, deposit betas will increase but are unlikely to catch up with loan pricing betas for several quarters. When they do net interest margins should still be increasing as most banks remain net asset sensitive. Simply put, the full benefit of net asset sensitivity was structurally delayed during 2017 and should contribute more fully over time, even if the Fed were to back off expected hikes, although we still expect another three increases for 2018 and continuance into 2019.

Loan mix is also an important factor. We aggregated the data by actual loan yield advance, separating out the top quintile weightings across four loan categories. Multifamily stands out as the greatest loan repricing retardant while commercial & industrial (C&I) is clearly an important accelerant.

Current Loan Composition – Sorted by Loan Yield Change Since Fed Hikes Began

	Loan Yield Change vs. 2015 (%)	C&I Loans/ Loans (%)	C&D Loans/ Loans (%)	CRE Loans/ Loans (%)	Multifamily Loans/ Loans (%)
All Banks	2%	17	7	31	9
Top Quintile	12%	26	6	24	5
Bottom Quintile	(8%)	12	6	32	15

Source: SNL Financial, Sandler O'Neill

In summary, bank earnings are beneficiaries of any improvement in the macroeconomic outlook, and particularly from business spending amplification. Also, bank net interest margins should surprise on the upside. While valuations in the sector are generally full, in our view, these two broad earnings stimulants should further drive bank stock performance in 2018.

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