



Bank stocks represent shareholders equity or residual real assets that are used to intermediate nominal assets and liabilities

Bank stocks represent real entities with earnings that should rise with inflation. A bank, like any other business, should be valued based upon all of its future cash flows. Just like any business, a bank's earnings and dividends should grow with inflation over the long-term even if none of its earnings are retained for reinvestment. Thus, just like any business, a fair PE on a bank's steady-state EPS is $1 / \text{real cost of equity}$ and a fair PB on a bank's steady-state book value is its sustainable nominal ROE / real cost of equity.

Banks stocks mostly represent real assets just like non-financial stocks

Although a bank's earnings should grow with inflation over the long-term, it is important to acknowledge that a bank's earnings are subject to the risk of unexpected inflationary/deflationary shocks. Abrupt changes in inflation expectations and/or inflation risk premiums and real interest rates, relative to the rates of return embedded in the income producing assets that a bank holds, or embedded in the rates of return of liabilities that a bank issues, can damage a bank's earnings power for the period of time it takes for any duration mismatch between its assets and liabilities to elapse. This issue along with leverage affects the path to normal EPS and real cost of capital (risk), but not the terminal value calculation. The perpetual growth rate of a bank's earnings should include inflation, i.e., its terminal value capitalization rate should be a real rate.

Earnings derived from real assets should grow with inflation even if no earnings are retained for reinvestment

The risk of change in the cost of capital relative to returns earned on assets is a risk that all businesses bear. Although this is generally a more significant risk for banks as relatively small interest rate changes (typical volatility) can significantly impact near-term EPS as amplified by leverage. However, banks are generally capable of adapting to secular interest rate shifts quicker than non-financial companies. What we mean is that the return that a bank earns will usually follow changes in the cost of capital more quickly up or down than non-financial companies. In a valuation sense, particularly for terminal value, banks are shorter duration than businesses that have more sticky returns relative to any cost of capital change. Businesses with sticky returns, especially if such returns are well above the cost of capital, are longer-duration equities. Long duration equities benefit in value from secular declines in capital costs, but suffer upon a secular climb in capital costs as the drivers of their returns are more independent.

More on why a bank's long-term EPS should grow with inflation

Retained earnings should be in assets producing returns inclusive of expected inflation. The retained earnings at banks represent many real assets, such as property, equipment, accumulated marketing, etc.; but much of it will be in nominal assets like loans and securities that make up most of the bank's assets. These nominal assets should produce returns that include an expected inflation rate. As discussed above, risk stems from changes in inflation from what is embedded in the returns from assets held.

For non-financial businesses, the ability to grow earnings and dividends with inflation even when no earnings are retained for reinvestment comes from the rising cost of replacing the real assets that underlie earnings. Thus, in order to keep the return on capital constant on the real value of capital employed prices need to rise with inflation. It might seem that raising prices on a constant capital base produces perpetually rising economic profits, but if the capital base is carried with an inflation adjustment then the return on capital stays constant. For businesses that are highly competitive with returns close to the cost of capital all this occurs via market forces. This is typical for commodity producers and other highly competitive or regulated businesses. This is why Energy and Utilities stocks are usually among the more effective inflation hedges.