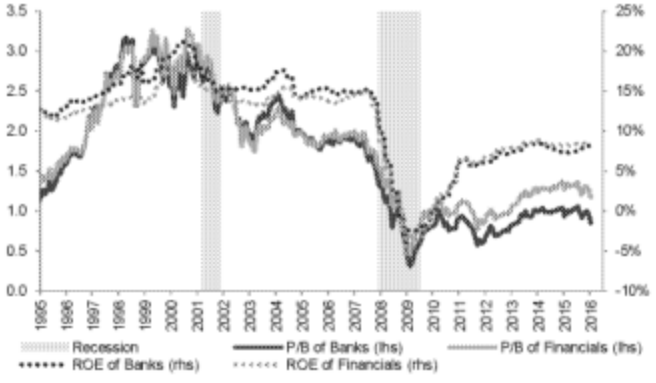
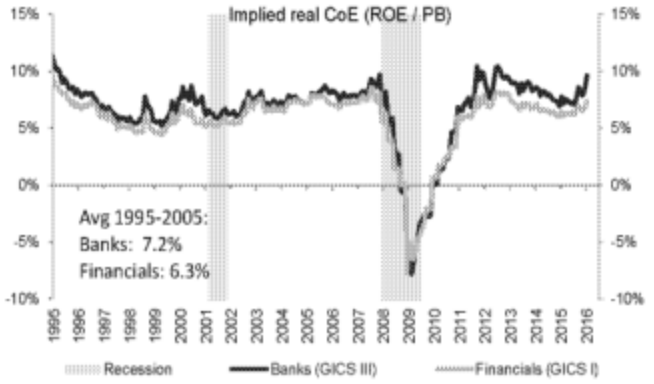
Figure 19: P/B and ROE of S&P 500 Banks and Financials



Source: IBES, Compustat, Deutsche Bank

Figure 20: Implied real CoE (ROE / PB) of S&P 500 Banks and Financials



Source: IBES, Compustat, Deutsche Bank

We consider banks to be highly competitive enterprises with little value added growth potential. Thus, we value banks using steady-state PEs based on 1/ real COE applied to normal EPS. This means the fair dividend yield is real COE * dividend payout ratio. Fair PB is *not* 1, but ROE/ real COE. The focus in valuing banks is normalized EPS and cost of capital, not long-term growth potential. Loan growth has been slow and is likely to stay so, but this valuation driver is less important as the higher dividend payout alternative can be equally attractive (or more) to shareholders.

Low long-term real interest rates justify a higher present value of any income stream regardless of source. But estimating steady-state EPS and the often multiyear path to such EPS is the crucial consideration for value stocks. For banks, visibility of normal EPS and the path toward it has been clouded by many uncertainties but we think they continue to make slow progress toward higher ROEs and dividend payout ratios.

Worth the wait: Banks must wait longer for an earnings boost from Fed hikes

We estimate that every 25bp climb in the annual average FF rate boosts S&P Banks EPS by 3-5% or nearly $0.50 of S&P EPS. Crucially, this assumes that credit costs do not exceed normal levels upon such higher overnight rates. We expect LLP provisions to climb to a more normal 65-85bp range in 2016-17 vs. 40-50bp in 2014-15. We explain our EPS sensitivity to FF rate estimates inside. Quantifying how much rate hikes benefit banks is very uncertain, but this is important to consider as a balance to moderately higher credit cost scenarios.

It will take a recession for credit costs to exceed normal and no hikes at all

Given disclosed exposures, energy won't cause LLPs to surge. Energy credit losses are unlikely to exceed 10% of loan values over a two year period. Less than 3% of bank loans are energy (w/ reserves already boosted) with 60% being IG, so if 20% default (half of non IG), with a 50% loss over 2 years, the loss is still under 15bp of all loans a year. Thus, it will take a recession with significant real estate value declines and job losses to get LLPs to 100bp or higher and to justify current Bank PEs unless Banks should normally be under 12x EPS. Every 25bp increase in LLPs reduces S&P Bank EPS by about 7% or $0.75 of S&P EPS. Thus, a 50bp climb in the FF rate should offset a normalization of credit costs; but credit costs likely normalize before the FF rate climbs.