The latest quarterly earnings reports from U.S. regional banks confirm the favorable investment outlook as loan growth and an improved interest-rate environment provide a tailwind for the industry, in the view of Ryan P. Lentell (Portfolio Manager) and Susan A. Curry (Senior Portfolio Manager).

U.S. banks' fundamentals continue to strengthen despite the economic slowdown

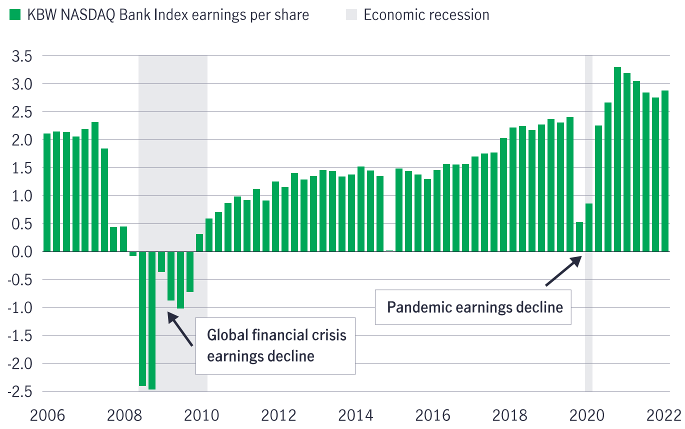
U.S. banks recently reported strong second-quarter results, with 69% of banks beating analysts' operating earnings-per-share expectations.[1] While year-over-year bank earnings declined nearly 3% on average, the setback was mainly attributable to banks' outsized credit reserve releases in last year's second quarter, which boosted earnings in the year-ago period that the most recent quarterly results were compared against. The 2021 credit releases occurred as banks normalized their reserves when it became apparent that the economy was healing more quickly than expected following the rollout of COVID-19 vaccines early last year.

U.S. banks' fundamental strengths

If we exclude these outsized credit reserve releases, the banking industry's strong core fundamentals shined. On average, banks' second-quarter earnings were 11.4% higher than the same period a year earlier, excluding credit costs and taxes.[1] From our analysis, this earnings growth was mainly driven by increased revenue, as banks benefited from both strong loan growth and the higher interest-rate environment resulting from recent U.S. Federal Reserve (Fed) rate hikes. In fact, on average, banks reported 12.6% annualized loan growth versus first-quarter 2022 levels. Meanwhile, their net interest margins (NIMs) expanded an average 23 basis points (bps) during the latest quarter as banks benefited from the higher rates they earned on loans and securities. This resulted in 8.7% net interest income growth versus this year's first quarter and 13.4% versus the year-ago period.[1]

U.S. bank earnings remain solid despite recent economic headwinds

KBW NASDAQ Bank Index quarterly earnings per share, Q1 2006–Q2 2022 ($)



Source: Bloomberg, as of August 10, 2022. The KBW NASDAQ Bank Index tracks the performance of leading banks and thrifts that are publicly traded in the United States. It is not possible to invest directly in an index. Earnings per share (EPS) is a measure of how much profit a company has generated calculated by dividing the company's net income by its total number of outstanding shares.

We continually evaluate market and economic risks, and one area of focus for us is the credit environment. Today, credit expense remains benign, in our view. Banks' nonperforming assets declined in the quarter by 4bps and stood at only 0.40% of assets on average.[1] In addition, net charge-offs as a percentage of average loans for small- and mid-cap banks were almost non-existent at only 2bps of total loans.[1] This translated into an average return on

[1] "KBW Bank Earnings Wrap-Up 2Q22, Final Ed: Ests. Mostly Rise as Stronger Est. '22 Modestly Tempers '23 Growth," Keefe, Bruyette & Woods, July 29, 2022.

assets of 1.18% and a healthy return on equity of 11.93%.[1]

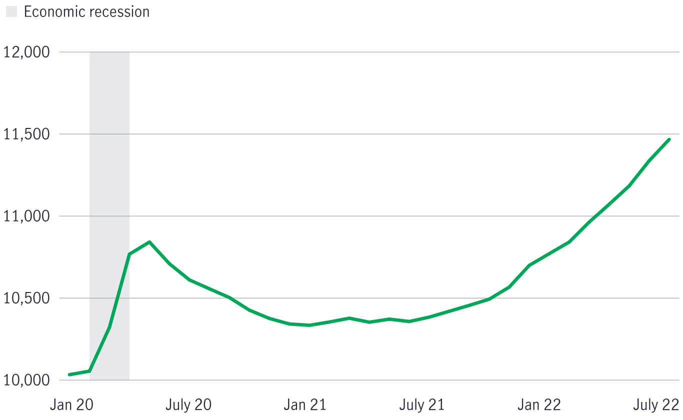
The macroeconomic and monetary policy environments and outlooks

These strong fundamentals for U.S. banks may seem counterintuitive, given headlines in the financial press emphasizing the recent economic slowdown. Despite these concerns, U.S. bank stocks generally responded well to the recent earnings results, as the S&P Composite 1500 Banks Index rose 7.8% in July.[2]

We expect many of the trends seen in the second quarter to persist into the second half of 2022 and into 2023. Revenue gains are likely to continue, benefiting from loan growth and the recent interest-rate hikes. Our research indicates that bank management teams are expecting healthy loan pipelines in the third quarter. While growth may slow from the elevated level in the second quarter, we believe it's likely to remain strong. In the wake of the Fed's two rate hikes of 75bps each in June and July, we expect NIMs will again increase meaningfully in the third quarter, leading to further revenue growth.

This year's economic slowdown hasn't eroded bank loan growth

Loans and leases, all U.S. commercial banks, seasonally adjusted, January 2020–June 2022 (US$ billions)



Source: U.S. Federal Reserve Bank of St. Louis, July 2022.

Additionally, we continue to hear that commercial borrowers remain resilient, with healthy balance sheets. While we're on the lookout for the negate ve effects of higher inflation, these price pressures don't appear to us to be translating into higher credit costs today. We expect credit expenses will eventually normalize to a higher level but believe that banks are well prepared with strong reserves and capital.

Finally, for investors, we believe that banks remain attractively valued on both an absolute and relative basis. Bank stocks were trading at 1.09x their book value as of August 10, 2022—a meaningful discount to their long-term average of 1.60x dating to the mid-1990s.[3] Moreover, on a relative basis, banks recently traded at about 55% of the forward price-to-earnings ratio of the broader market.[4] Overall, this appears to be an attractive entry point for investors given the strong fundamental trends noted above.

[2] FactSet, July 31, 2022. The S&P Composite 1500 Banks Index tracks the performance of publicly traded large- and mid-cap banking companies in the United States. It is not possible to invest directly in an index.
[3] FactSet, as of July 31, 2022, for the S&P Composite 1500 Banks Index relative to its average dating to December 31 1994.
[4] FactSet, as of August 10, 2022. The 55% figure represents a forward price-to-earnings ratio of 9.80x for the S&P Composite 1500 Banks Index and 17.78x for the S&P 500 Index. The S&P Composite 1500 Banks Index tracks the performance of publicly traded large- and mid-cap banking companies in the United States. The S&P 500 Index tracks the performance of 500 of the largest publicly traded companies in the United States. It is not possible to invest directly in an index.

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