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Cheryl Pate, Senior Portfolio Manager @ Angel Oak Capital Advisors, LLC on Banking Sector

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Cheryl Pate

Cheryl Pate sat down with Jane King on August 15th, 2023 for a NAVigator Interview and discussed the banking sector.

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Jane King: Cheryl Pate is a senior portfolio manager at Angel Oak Capital and serves as the portfolio manager for the Financials Income Impact Fund and the Financial Strategies Income Term Trust, as well as two ETFs and several of the firm's private funds and separately managed accounts. Cheryl has nearly two decades of investment experience and primarily focuses on investment research and management across the firm's financial sector focused strategy. So Cheryl, great to have you here, I'm looking forward to our discussion about banks. It's been quite a year for the banking sector.

Cheryl Pate: It certainly has.

Jane King: So let's start with just your overall view. Of course we went through all the volatility in March, we saw the failures of some banks. How do you see banking right now?

Cheryl Pate: Yeah, we're actually very bullish on the banking sector today. I think when we step back, and clearly it's been a volatile several months here starting with the failures of Silicon Valley and Signature Bank mid-March, but as we've now been through a couple earnings seasons post those failures, we're pretty positive on the sector. If we step back and think about what has happened since then, I think, number one, a lot of the contagion risk fear has faded, but separately from that we are also in a different place in the rate environment, we’re pretty near or at the end of the Fed rate hike cycle.

And again, we’ve seen bank earnings, I think have been very resilient, we’ve seen, yes, some increases in deposit costs, but largely managing through some of those volatility and liquidity concerns and credit is holding in well. So we’ve seen bank equities have started to recover, we’ve seen issuance from the large and regional banks, and I think more importantly we’re also seeing a resurgence of M&A which we think will be a big theme in 2024.

Jane King: Okay, I want to talk to you a little bit more about that in a second, but do you see any regulation changes either as a result of the regional bank situation we went through or anything else?

Cheryl Pate: I do expect that there will be tighter regulations that come out of the back of this, and at the same time here, we’ve had discussions around Basel III endgame for the larger banks. I do think at the margin where we expect the biggest change will be the regional banks, the hundred billion to $250 billion cohort, and that’s where regulations were lightened to some degree over the past several years. And again, that’s where we saw some of the volatility and concern. So what do we expect going forward? Higher capital levels, higher liquidity levels, and all of that is good for the safety and soundness of the banking sector but also really good for investors in bank debt.

Jane King: And we will be getting bank earnings coming up here as the earnings season starts to come through. What should we look for? What would be the key things that you think are important in those reports?

Cheryl Pate: Yeah, I do think it’s going to be really important to focus on, number one, I think the deposit betas are still going to be the biggest question going forward. Clearly there has been a shift in how we think about duration of deposits and how willing banks are to pay up for some parts of their deposit structure, so that’s number one topic that all eyes will be on. But I think we’re also watching loan growth, we’re seeing tighter lending standards come through, we saw that in the senior loan officer survey, that is expected.

And then the third thing that I think we’re watching for over the next several quarters is some normalization of credit costs, and we’re still sitting a really good part of the cycle. Credit costs are in line with pre-pandemic 2019 levels, but we do expect that to normalize. And we’re particularly concerned about office commercial real estate, but that’s really not a significant portion of a lot of these banks’ balance sheets. So those are really the top three items to focus on.

Jane King: That’s interesting. You mentioned M&A earlier, do you see more of that? And would this be bigger banks buying some of the smaller regionals? What might that mean for the whole banking industry?

Cheryl Pate: Yeah, when we step back and think about it, the US is still highly over-banked, we still have 5,000 banks in the country, and clearly there has been a consolidation trend for a number of years. Typically we’ve consolidated about 5% per year, and that’s clearly been on pause during the current market volatility. Now if we're talking about a tougher earnings growth environment and higher regulation costs, that's going to weigh in on how banks think about consolidation, which typically is done for cost-save purposes. You're typically able to extract significant cost savings from the consolidation with another bank.

Now I think there will not be a lot of regulatory willingness for large bank consolidation, and that's been a theme for several years, but where we do think it'll be the most prevalent is probably at the large end of the community banks scale into some of the regional banks that are really going to be most impacted by higher regulatory costs. So that's really where we expect a pick-up as these costs come through over the next several quarters, and it is typically a somewhat smaller bank being acquired by a larger bank. We've also seen a lot of mergers of equals in recent years, and we may see that theme re-emerge as well.

Jane King: What about opportunities in banks for investors out there?

Cheryl Pate: Yeah, I think in our minds the great opportunity set today is in bank debt. We're able to see equity-like returns for investment grade bank debt. Because the fixed-income market seems to be a little bit slower to rebound following these types of events, it tends to follow the equities. We haven't seen that degree of spread tightening that we would expect come through yet, and so we're able to source opportunities in bank debt that is yielding mid-teens yield to call, mid, I would say around 10-ish percent, on a yield to maturity basis, and that's very compelling given that we don't think there is systemic credit concern liquidity concern for the sector as a whole.

Jane King: Okay, very interesting. Well, Cheryl, thank you so much for sharing your insight.

Cheryl Pate: Thank you so much.

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