Investment Strategy Update

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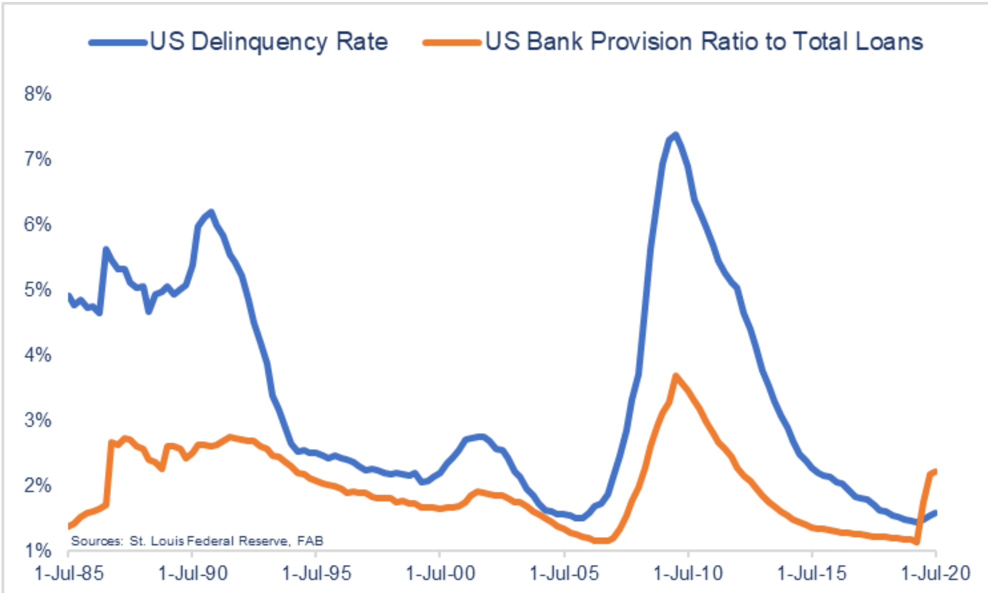
The Fed and banks have managed this crisis well so far

♦ **Bank loan-loss provisions as a percentage of total loans are the highest since 2010.**

♦ **However, partly thanks to the swift action of politicians and the Federal Reserve, actual defaults have not increased as much as expected.**

♦ **This bodes well for bank earnings this year and has recently prompted some analysts to upgrade the sector.**

♦ **The FAB AAC is overweight in equities, IG and EM bonds, and gold, and is underweight in alternatives.**



Last year's crisis was economic and, unlike many forecasts, did not turn into a financial crisis. Perhaps because of the scars left by the 2008 crisis, Washington, the Federal Reserve, and the US banking system have done a better job of taking all the necessary actions very quickly to stop that from happening. The same can be said of many countries across the globe.

This bodes well for the future, particularly of banks. The recent past has not been that bad either. As banks wrap up their earnings season, many of the results have revealed positive surprises, which has prompted a 16.71% rally in the S&P 500 financials subindex since 17 November.

Many of the gains, particularly for the biggest banks, were focused on revenues from fees and commissions, which increased amid a flurry of deals and securities trading. Meanwhile, the biggest drag, even into the fourth quarter, was an increase in loan-loss provisions as risk officers bulked up bank reserves, expecting a rise in loan delinquency rates.

Those provisions reduce earnings when they are taken, but can boost profits when reversed. Judging by the latest delinquency data, banks could start reversing some provisions this year.

According to the St. Louis Federal Reserve Bank, which tracks bank stability measures, between October, 2019, and April, 2020, US banks boosted their loan-loss reserves to 2.2% of total lending from 1.2%. By July, the latest data available, the ratio remained above 2.2% and rising.

Meanwhile, the actual share of all commercial bank loans that have gone unpaid was still at 1.6% in July, just a small uptick from the 1.5% at which it stood before the US lockdowns began.

A look at the components of the loan delinquency rates helps to explain this. There was a small rise in bad loans in commercial real estate and corporate loans, but the bad loan rate for many kinds of consumer loans fell to record lows.

The loan-loss provision ratio of US banks rose above actual delinquency rates last year

This could easily be attributed to the success of the US's Paycheck Protection Program. As consumers lost their jobs but got bigger than expected welfare checks, many rushed to pay their credit cards and other personal loans.

Given the continuity of the program and the upcoming relief package being negotiated in Washington, it makes sense to assume that the delinquency rate will not climb significantly from July of last year, and Fed officials made comments that suggested this in the minutes of the latest FOMC meeting.

If that is the case, banks could start reversing their loan-loss provisions in coming quarters, further boosting their profits, and, potentially, their share prices.

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