



Insigneo Weekly Dispatch

# Banks, A Turbulent Story For 2024

What are banks trying to tell us about 2024?

**By Andrés Salamanca**

Research and Data Science Analyst  
Insigneo

## Banks, A Turbulent Story For 2024

“Markets are not the economy” is a phrase that can sum up last year. With the enthusiasm behind the Artificial Intelligence boom, markets blew past the current macroeconomic landscape and looked forward to yet unrealized gains in productivity and profitability from the rapid adoption of this general purpose technology. Last year, it became more popular to hear about the “Magnificent 7” as they were primarily driving the S&P 500’s returns. Well, with one month into 2024, things have not changed much. Although Tesla (TSLA) reported a 40% non-GAAP EPS decline year-over-year, the remaining Magnificent 7 are expected to beat consensus and outperform the rest of the index. According to Factset, the remaining 494 companies in the S&P 500 (Including TSLA) are expected to see a year-over-year earnings decline of 10.5% for 2023. While it is still too early to determine the overall performance of the different sectors that comprise the index, there is one sector that has caught our attention – the banks. Within the Financials, banks negatively surprised markets with worse-than-expected EPS for 4Q23. While banks’ stocks underperformed after their respective earnings releases, most of them ended January in positive territory, with Citigroup (C) leading the race with a 9.2% return for the month. But why did earnings come so low for the quarter? In summary, while higher interest rates benefited banks’ revenues, they also shrunk their margins. Deposit costs for the banks, measured by deposit betas, have been consistently increasing since the

interest rate hikes began in 2022. Deposit betas were on average 49% among the top 7 banks in the United States as of 4Q23, which means that banks have passed along 49% of the Fed's interest rate hikes to their customers in the form of higher deposit rates. In other words, every day it is more expensive for banks to provide deposit accounts. The mix of saving accounts, certificate of deposits, and non-interest-bearing (non-IB) accounts have continued to change, as non-IB accounts continued to decrease, falling below their historical average (~25% of total deposits).

In addition to lower margins, loan portfolios have been shrinking among banks, as Commercial and Industrial loans (C&I loans) further weakened during the quarter. Corporate clients have remained on the sidelines expecting rate cuts. On the other hand, lower C&I loans have been partly offset by higher credit card loan balances. As we have been hearing on the news, consumers are running out of savings, but they have not stopped spending. Credit card spending growth over the year was 14% at JP Morgan (JPM), 13% at Wells Fargo (WFC), 9% at Bank of America (BAC), and 9% at Citigroup (C). While credit card growth has "sustained" banks' loan portfolios, net charge-off (NCO) ratios, or debt that is unlikely to be recovered, raised to levels last observed in 2014. In fact, this was the 5th straight quarter that every bank added to its credit card loan loss reserve. Lastly, mortgages have also been contracting, as the 30-year residential mortgage rate rose to 7.3% by the end of the year.

But it's not all bad news. Banks managed to control expenses during the year by closing branches,

reducing headcount, and lowering its labor force incentive compensation. In addition, capital markets had an overall strong year, with revenue above pre-pandemic levels driven by equity and fixed income trading. Still, IPOs and debt issuance are still 36% and 29% below 4Q19 numbers, respectively.

So, we should ask ourselves, why are bank stocks rising? The quick answer is the now famous term "Soft Landing". After some volatility experienced during the earnings release dates, markets have shown increased confidence in the Fed avoiding a recession. The main expectation is that under a soft landing scenario, most of the negative items that we discussed above will start to normalize. Investors' confidence is relying on the magnitude of the rate cuts that the US economy will experience during 2024. With lower interest rates, banks will improve their margins with lower deposit betas, bringing back corporate clients that have not accessed debt due to high interest rates (as well as mortgage and auto loan customers), and will relieve pressure from their NCO reserves. However, if we stick to the banks' full-year guidance, 2024 will be a murky year for financial institutions. Net interest income is expected to bottom out during the first half of the year with recovery expectations for the second half of 2024. Consumer deposits are expected to shrink during 2024, and deposit cost will continue to increase at a slower pace, with some relief by the end of the year. Loan portfolio growth will focus on credit card loans, with low expectations for C&I recovery this year. Credit card loans will benefit from less savings and from rate cuts. Most of the banks are focusing their efforts on cost efficiency measures

to offset lesser revenues. NCO ratios should continue to rise with an increase in delinquencies and non-performing loans, but banks are capitalized to face a modest recession. JP Morgan (JPM) was the only bank to provide a positive net interest income guidance for the year, with Wells Fargo (WFC), US Bancorp (USB) and PNC providing up to 9%, 5% and 5% decline guidance, respectively. Other banks like Citigroup (C) or Wells Fargo (WFC) will mainly focus on cost efficiencies. Citigroup announced that it will be exiting 14 international markets and simplifying its organizational structure for this purpose. As we stated at the beginning, it is important to remember that markets are not the economy. While markets are expecting a soft-landing

scenario and indexes are being pushed by Artificial Intelligence, near-term macroeconomic expectations are still uncertain, and banks' guidance is the perfect reminder of this. ■



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