US BANKS

Five questions for 3Q21; is a growth inflection coming?

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- **Third quarter 2021 results season kicks off.** US money center banks report between Wednesday, October 13 and Friday, October 15. Industry observers should focus on five questions (net interest income/pre-provision profits, loan growth, fintech, capital markets, credit quality) during earnings season. This report provides thoughts on each. We focus on JPMorgan, Bank of America, Citigroup, and Wells Fargo to illustrate banking system trends, though Morgan Stanley and Goldman Sachs are also discussed in the context of capital markets businesses.

- **Extraordinary policy measures have hurt growth, but helped credit quality; is growth coming?** Fiscal and monetary policy stimulus have cushioned the economic blow of the pandemic and helped trigger a recovery. However, policy stimulus has also pressured loan balances and net interest income (NII). In fact, the discrepancy between remarkable deposit growth and lower loan balances is striking. At JPMorgan, Bank of America, Citigroup, and Wells Fargo alone, deposits grew collectively by a staggering $1.6 trillion between December 2019 and June 2021, while loans *declined* on aggregate by $154 billion. Nonetheless, we think management outlooks on earnings calls could support more optimistic assessments about growth trajectories beyond 3Q21.

- **Loan growth is critical; direction of travel seems encouraging.** The single most important measure to focus on in 3Q21 is loan growth, in our view. The re-emergence of loan growth, especially if coupled with higher interest rates, could drive NII and, by extension, pre-provision profits higher. While loan growth is likely to remain muted in 3Q21, we note that loan evolution improved moderately in 2Q21 and credit card balances bottomed in late 1Q21 and are now growing. Equally important, policy normalization could help reduce paydowns, thereby helping loan growth re-emerge. We note that financial markets have thus far viewed growth pressures as transitory as US bank stocks have outperformed year-to-date.

JPMorgan kicks off third quarter 2021 earnings season on Wednesday (October 13). Citigroup, Bank of America, Wells Fargo, Goldman Sachs, and Morgan Stanley report on October 14 and 15 (see table below). In our view, the quarterly results will begin to provide a window into how the undoing of extraordinary fiscal and monetary expansion will impact operational and financial outlooks. The unprecedented post pandemic policy stimulus has not been universally positive for US banks. While policy measures (including forbearance) have supported credit quality, NII and pre-provision profitability have generally stagnated due to low interest rates and limited borrowing demand. Financial markets, however, have mostly seen lackluster top line dynamics as transitory. In fact, the KBW bank index (BKX)[1] has outperformed the S&P 500 by 22 percentage points year-to-date (YTD) given expectations for continued economic strength, higher interest rates, and an eventual acceleration in loan and net interest income growth.

3Q21 will begin to provide a window into how the undoing of extraordinary fiscal and monetary expansion will impact outlooks

A busy three days: release dates and conference call details

Company	Date	Conf call time (eastern US)	Call in details
JPMorgan	10/13/2021	8:30 AM	1-866-659 9159 (US/Canada)1-617-399 5172 (outside US/Canada) PC: 26483228#
Morgan Stanley	10/14/2021	8:30 AM	1-877-895-9527 (US)/1-706-679-2291 (outside US) PC: 3958264
Bank of America	10/14/2021	9:00 AM	1-877-200-4456 (US)/1-785-424-1732 (outside US) PC: 79795
Citigroup	10/14/2021	10:00 AM	1-866-516-9582 (US/Canada)/1-973-409-9210 (outside US/Canada) PC: 2976824
Wells Fargo	10/14/2021	11:30 AM	1-877-918-2317 (US/Canada)/312-470-7164 (outside US/Canada) PC: 1382313
Goldman Sachs	10/15/2021	10:30 AM	1-888-281-7154 (US)/1-706-679-5627 (outside US)

Note: All earnings reports will be released before market. Source: Company reports

This report addresses key questions that industry observers should focus on. Most important, in our view, will be outlooks for loan, net interest income, and pre-provision profits.

[1] The BKX is a market cap weighted index composed of 24 national money center banks and leading regional institutions.

Question 1: Will 3Q21 results and commentary suggest that net interest income and pre-provision profits are inflecting?

NII has likely bottomed, and managements could reinforce more optimistic revenue and pre-provision profit outlooks

Extraordinary policy measures have cushioned the effects of the pandemic and precipitated a strong recovery. Perhaps counterintuitively, though, they have also hurt bank NII

Bank share outperformance has occurred even though NII and pre-provision profits[2] have generally been under pressure due to low interest rates and falling loan balances. In fact, lackluster NII and pre-provision profit evolution are even more notable considering very strong sales and trading and investment banking results since the pandemic (see more under question 4 below). The US federal government's extraordinary fiscal and monetary policy measures have helped cushion the effects of the pandemic and precipitated a strong economic recovery. Perhaps counterintuitively, though, they have hurt NII as the Fed Funds rate was lowered to the zero bound, long-term rates fell (though they have risen materially in recent weeks), and borrowers (especially consumers) have used stimulus payments to pay down debt. Credit card paydowns have especially spiked. In addition, corporates' access to capital markets financing and elevated cash balances have meant that utilization rates on lines of credit are at or near historic lows. Supply chain disruptions have also hurt borrowing demand.

The exhibit below excludes Goldman Sachs and Morgan Stanley as capital markets-oriented activities represent a greater proportion of revenue versus NII. For JPMorgan, Bank of America, Citigroup, and Wells Fargo, NII declined 9-17% Y-Y in 1H21. In addition, for JPMorgan, Bank of America, and Citigroup pre-provision profits fell in 1H21 versus 1H20. Moreover, we note that Wells Fargo's pre-provision profit growth is somewhat misleading as 1H21 results include notable non-core items that boosted revenue and earnings when compared to 1H20. More important, in our view, is that Wells Fargo's NII declined a sizable 17.0% Y-Y in 1H21.

[2] Defined as total revenue minus operating expenses. Pre-provision profits are before loan loss provisions. The measure is often used as a gauge of core profitability when loan loss provisions are abnormally high or low. We think pre-provision profits are especially important currently. After sizable additions to loan loss reserves in 1H20 to factor in potential economic deterioration, US banks have been "releasing" loan loss reserves as actual losses are likely to be lower than what was expected in the initial phase of the pandemic. These releases have boosted reported net incomes of many banks since 4Q20. Volatility in loan loss reserving has been especially elevated in the US given the adoption of a new accounting standard for loan loss reserving on January 1, 2020 (Current Expected Loss Model, or CECL).

NII and pre-provision profits have generally been under pressure for the largest US commercial banks

$ mn, unless otherwise noted	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21	1H20	2H21
JPMorgan								
Net interest income	14,439	13,853	13,013	13,258	**12,889**	**12,741**	**28,292**	**25,630**
% growth, Y-Y					***-10.7%***	***-8.0%***		***-9.4%***
Pre-provision profits	11,495	16,133	12,380	13,287	**13,541**	**12,812**	**27,628**	**26,353**
% growth, Y-Y					***17.8%***	***-20.6%***		***-4.6%***
Bank of America								
Net interest income	12,130	10,848	10,129	10,253	**10,197**	**10,233**	**22,978**	**20,430**
% growth, Y-Y					***-15.9%***	***-5.7%***		***-11.1%***
Pre-provision profits	9,292	8,916	5,935	6,172	**7,306**	**6,421**	**18,208**	**13,727**
% growth, Y-Y					***-21.4%***	***-28.0%***		***-24.6%***
Citigroup								
Net interest income	11,492	11,080	10,493	10,483	**10,166**	**10,199**	**22,572**	**20,365**
% growth, Y-Y					***-11.5%***	***-8.0%***		***-9.8%***
Pre-provision profits	10,088	9,306	6,338	5,395	**8,254**	**6,282**	**19,394**	**14,536**
% growth, Y-Y					***-18.2%***	***-32.5%***		***-25.0%***
Wells Fargo								
Net interest income	11,330	9,892	9,379	9,355	**8,808**	**8,800**	**21,222**	**17,608**
% growth, Y-Y					***-22.3%***	***-11.0%***		***-17.0%***
Pre-provision profits	5,125	3,735	4,087	3,687	**4,543**	**6,929**	**8,860**	**11,472**
% growth, Y-Y					***-11.4%***	***85.5%***		***29.5%***

Source: Company reports

However, we think reasons exist to be more optimistic. On a sequential basis, NII appears to have stabilized in 2Q21. Perhaps more importantly, recent commentary or guidance from each bank suggests that NII should either stabilize or grow in 3Q21 and 4Q21 versus quarterly run rates in 1H21.

More fundamentally, the easing of policy stimulus could boost NII in a handful of ways. First, while Fed rate hikes will likely wait until at least 2022 (and US banks are generally more sensitive to the short end of the curve), tapering could contribute to continued increases in medium to long term rates, boosting yields on new securities purchases (cash balances at banks are extraordinarily high currently). In addition, less stimulus could drive lower (e.g., normalizing) savings rates and, by extension, lower pay downs on higher margin credit card loans. As noted below, credit card balances have already been rising since late 1Q21. Moreover, easing supply chain disruptions could also contribute to faster commercial loan growth.

Question 2: Will loan growth pick up?

Total loan growth likely remained muted in 3Q21, but outlooks may be more optimistic beyond 3Q21

This question is related to question 1. However, it deserves its own treatment, in our view. In fact, if there is one measure to focus on in the quarterly results, it is loan growth. We think both the quarterly trend and the outlooks provided managements will be important to industry observers. The pandemic has led to dramatic changes in US bank balance sheets since the pandemic. In particular, policy stimulus has contributed to substantial deposit inflows, but bank loan balances have declined.

The figures below are illustrative. At JPMorgan, Bank of America, Citigroup, and Wells Fargo alone, deposit balances grew a staggering $1.6 trillion from year end 2019 through June 2021, while loan balances declined a cumulative $154 bn over the period (only JPMorgan showed loan growth). In other words, deposits outgrew loans by about $1.7 trillion. A substantial proportion of these "excess deposits" are being held at the Federal Reserve earning little interest income. Loan to deposit ratios (a measure of funding availability) now stand at historically low levels.

Deposits grew by almost $1.6 trillion for JPMorgan, Bank of America, Citigroup, and Wells Fargo collectively since year end 2019 while loans declined . . .

	Deposits ($ mn)		Change		Loans ($ mn)		Change	
	4Q19	**2Q21**	**$ mn**	**%**	**4Q19**	**2Q21**	**$ mn**	**%**
JPMorgan	1,562,431	2,305,217	742,786	47.5%	997,620	1,040,954	43,334	4.3%
Bank of America	1,434,803	1,909,142	474,339	33.1%	983,426	918,928	(64,498)	-6.6%
Citigroup	1,070,590	1,310,281	239,691	22.4%	699,483	676,834	(22,649)	-3.2%
Wells Fargo	1,322,626	1,440,472	117,846	8.9%	962,265	852,300	(109,965)	-11.4%
Total	**5,390,450**	**6,965,112**	**1,574,662**	**29.2%**	**3,642,794**	**3,489,016**	**-153,778**	**-4.2%**

Source: Company reports.

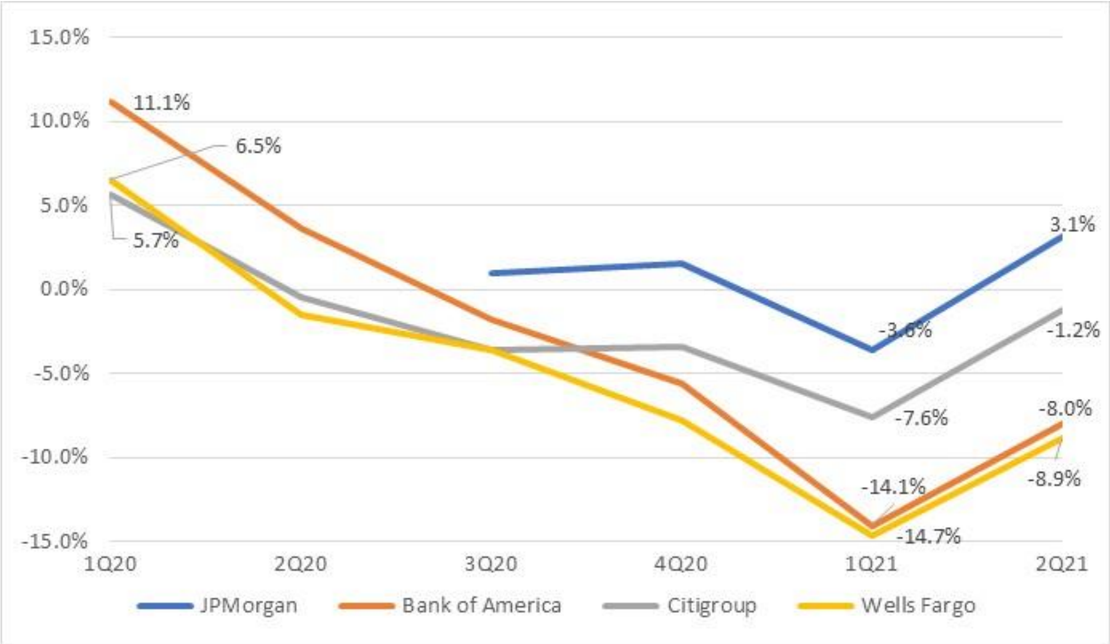
. . . leading to extremely low loan to deposit ratios

	4Q19	**2Q21**
JPMorgan	64%	45%
Bank of America	69%	48%
Citigroup	65%	52%
Wells Fargo	73%	59%
Total	**68%**	**50%**

Source: Company reports.

However, recent trends and management commentary suggest some optimism is warranted. While loan balances still declined Y-Y for Wells Fargo, Bank of America, and Citigroup in 2Q21 (JPMorgan showed a modest Y-Y rise), they rose Q-Q for Bank of America, Citigroup, and JPMorgan (and even Wells Fargo showed a lesser Q-Q decline). In addition, commentary from some US banks at a recent investor conference (including from larger regional banks) suggested that while continued low utilization rates on commercial lines could weigh on loan growth, commercial loan demand is showing signs of life. In addition, weekly data from the Federal Reserve shows that credit card and other revolving loan balances continued rising in 3Q21 after troughing in late 1Q21. We think this bodes particularly well for JPMorgan and Citigroup, where US credit cards represent a proportionally larger share of loans and drive greater amounts of NII.

Loan balances continued declining year-over-year Y-Y in 2Q21 for Citigroup, Bank of America, and Wells Fargo . . .



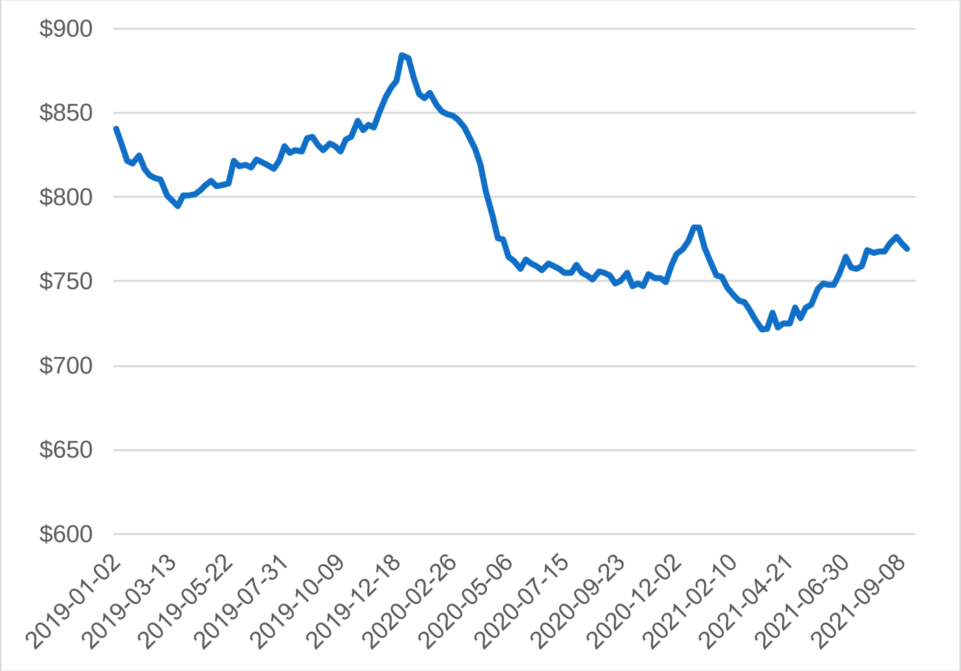
Note: We do not show JPMorgan's Y-Y loan growth in 1Q20 and 2Q20 in the exhibit above as restatements of historical loan balances in financial reporting could make Y-Y comparisons inaccurate in these time periods. Source: Company reports.

. . . but quarter-over-quarter (Q-Q) loan balance evolution was more positive

	2Q20	3Q20	4Q20	1Q21	2Q21
JPMorgan	-0.6%	-1.9%	2.3%	-0.2%	2.9%
Bank of America	-4.9%	-4.4%	-2.9%	-2.7%	1.8%
Citigroup	-5.0%	-2.7%	1.3%	-1.5%	1.6%
Wells Fargo	-7.4%	-1.6%	-3.5%	-2.9%	-1.1%

Source: Company reports

Credit card and other revolving loan plan balances have rebounded off lows for US commercial banks (US$ billions)



Source: Federal Reserve weekly H8 data through September 22, 2021

Question 3: Is competition from fintech a growing concern?

Managements could be asked about strategies in select businesses, including Buy Now Pay Later (BNPL), though fintech disruption is unlikely to be a near-term driver of reactions to results

Our experience has been that US based investors are less focused than investors in other markets about the threats to structural growth and profitability from fintech. Ultimately, though non-bank competitors have taken share from banks in select businesses, the largest US banks nonetheless generated strong profitability levels even prior to the pandemic in a historically low interest rate environment. For example, JPMorgan and Bank of America posted returns on tangible common equities (ROTCEs) of 19% and 15%, respectively, in 2019[3]. We also note that technology has also benefited large banks by helping to reduce costs and enhancing the stickiness of existing client relationships. This is especially true for the national

[3] 2020 and 1H21 ROTCEs are not good approximations of core profitability, in our view. For most banks, 2020 earnings were adversely impacted by substantial loan loss reserve builds to reflect potential losses given expected economic deterioration. By contrast, 21 year to date earnings have been inflated by reversals of loan loss reserves as economic outcomes have been better than expected.

banks whose technology budgets dwarf those of regional peers. However, we think industry participants are increasingly focused on disruption and its possible medium to long term impacts on growth and profitability. These concerns were laid out by Jamie Dimon, JPMorgan's Chief Executive Officer (CEO), in his most recent annual shareholder letter (see ceo-letter-to-shareholders-2020(jpmorganchase.com).

Ultimately, we think strategies around Buy Now Pay Later (BNPL) will be a focus area given the recent pressure on card lending and concerns about potential competition emanating from new payment options and credit products. In our view, bank managements likely indicate that they are looking to introduce or expand BNPL and point of sale installment products given demand from clients for these options. However, we don't think that BNPL or fintech disruption represent near term threats to a cyclical recovery in growth.

Question 4: Will sales and trading and investment banking revenue begin to normalize from abnormally elevated levels?

Sales and trading income could moderate somewhat but IB fees are likely to remain strong

Sales and trading results for US money center banks have been exceptionally strong during the pandemic given considerable market volatility (see second figure below). In addition, 2021 is shaping up to be a banner year for investment banking. However, current revenue levels are unlikely to be sustainable and market participants generally look past healthy earnings driven by abnormally high sales and trading results. Hence, we think market attention will be focused on outlooks for sales and trading and IB results. At a recent investor conference, managements indicated that sales and trading income should generally continue moderating in 3Q21, though remain at healthy levels. Investment banking fees should stay elevated, especially equity capital markets and M&A.

The table below shows the recent evolution of sales and trading (FICC plus Equities) and investment banking fees for JPMorgan, Bank of America, Citigroup, and Wells Fargo, along with Morgan Stanley and Goldman Sachs. For sales and trading, we also show annual revenue levels from 2018 to 2020 to give readers a sense for how far above trend recent results have been. We note that JPMorgan posted sales and trading income of over $29 bn in 2020, compared to an annual range of $18-21 bn from 2010 to 2019.

Sales and trading revenue has remained elevated while investment banking fees are exceptionally strong

Sales and trading	**1Q20**	**2Q20**	**1Q21**	**2Q21**	**1H20**	**1H21**
$ mn, unless otherwise notes						
JPMorgan	7,230	9,718	9,050	6,787	16,948	15,837
% Y-Y growth			*25.2%*	*-30.2%*		*-6.6%*
Bank of America	4,635	4,151	5,078	3,561	8,786	8,639
% Y-Y growth			*9.6%*	*-14.2%*		*-1.7%*
Citigroup	5,955	6,365	6,026	4,269	12,320	10,295
% Y-Y growth			*1.2%*	*-32.9%*		*-16.4%*
Goldman Sachs	5,163	7,176	7,581	4,900	12,339	12,481
% Y-Y growth			*46.8%*	*-31.7%*		*1.2%*
Morgan Stanley	4,511	5,668	5,841	4,509	10,179	10,350
% Y-Y growth			*29.5%*	*-20.4%*		*1.7%*
Wells Fargo	1,202	1,947	1,432	1,078	3,149	2,510
% Y-Y growth			*19.1%*	*-44.6%*		*-20.3%*

Note: Includes Fixed Income, Currencies, and Commodities (FICC) and Equities

Investment banking fees	**1Q20**	**2Q20**	**1Q21**	**2Q21**	**1H20**	**1H21**
$ mn, unless otherwise notes						
JPMorgan	1,907	2,847	2,988	3,572	4,754	6,560
% Y-Y growth			*56.7%*	*25.5%*		*38.0%*
Bank of America	1,388	2,159	2,246	2,122	3,547	4,368
% Y-Y growth			*61.8%*	*-1.7%*		*23.1%*
Citigroup	1,354	1,759	1,973	1,772	3,113	3,745
% Y-Y growth			*45.7%*	*0.7%*		*20.3%*
Goldman Sachs	1,742	2,733	3,566	3,450	4,475	7,016
% Y-Y growth			*104.7%*	*26.2%*		*56.8%*
Morgan Stanley	1,144	2,051	2,613	2,376	3,195	4,989
% Y-Y growth			*128.4%*	*15.8%*		*56.2%*

Note: Includes equity and debt capital markets and M&A

Source: Company reports

Sales and trading income accelerated materially during the pandemic

	2018	2019	2020
$ mn, unless otherwise notes			
JPMorgan	19,594	20,912	29,483
% Y-Y growth		*6.7%*	*41.0%*
Bank of America	13,171	12,682	15,017
% Y-Y growth		*-3.7%*	*18.4%*
Citigroup	15,088	15,792	20,880
% Y-Y growth		*4.7%*	*32.2%*
Goldman Sachs	14,438	14,779	21,157
% Y-Y growth		*2.4%*	*43.2%*
Morgan Stanley	13,981	13,602	18,625
% Y-Y growth		*-2.7%*	*36.9%*
Wells Fargo	NA	4,832	5,544
% Y-Y growth			*14.7%*

Note: Includes Fixed Income, Currencies, and Commodities (FICC) and Equities. Source: Company reports

Question 5: Did credit quality remain exceptionally good in 3Q21? Will it persist as policy stimulus eases?

Credit quality likely remained stellar

While expansionary fiscal and monetary policy hurt loan and NII growth, it helped credit quality. In fact, net charge off (NCOs) and delinquency ratios are at historically low levels. In addition, reported bank earnings in 2021 have been turbocharged by the release of loan loss reserves that had been established early in the pandemic to cover expected credit losses. Recent management commentary suggests that loan loss reserve reductions could continue, albeit at much more modest levels than in recent quarters. In addition, net charge offs are likely to remain very low in 3Q21. We do note, however, that market participants are unlikely to expect the current exceptional credit quality to persist for an extended time period when forecasting future earnings power.

Even then, we don't see imminent signs of credit quality worsening. Consumer balance sheets remain healthy for bank customers. We also note that large systemically important US banks subject to stress tests have de-risked credit portfolios substantially since the global financial crisis.