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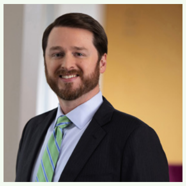
FROM RESILIENT TO RISKY AND BACK: THE RECOVERY OF REGIONAL BANKS



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The lesson from the past two years is clear: regional banks are far more resilient than the market gave them credit for during the 2023 banking crisis. That said, the risks of complacency remain. With the potential for slower economic growth ahead, maintaining discipline in underwriting and capital management will be critical. For now, though, the sector's fundamentals and improving technicals suggest that regional banks have moved from a story of survival to one of opportunity.

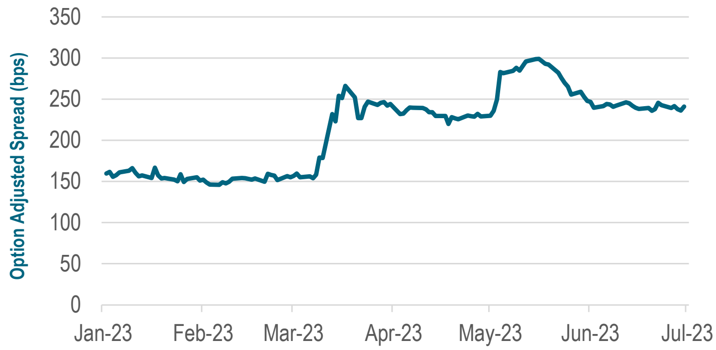
THE 2023 BANKING CRISIS

For years after the Great Financial Crisis, large[1] regional banks were the picture of stability — steady, unremarkable credits that rarely caught the spotlight. That changed dramatically in March 2023 when Silicon Valley Bank and Signature Bank collapsed in rapid succession. These failures exposed vulnerabilities across the sector, shaking the market's confidence in regional banks and prompting investors to view them as one of the riskiest segments of the corporate credit market.

The triggers were clear. In just 12 months, the Federal Reserve raised rates from zero to 4.50% – 4.75%, putting regional banks under intense pressure. Higher rates caused depositors to pull funds from accounts offering little or no yield, while also slashing the value of banks' low-interest loans and low-yielding securities investments. At the same time, fears of an economic slowdown raised concerns over credit quality, particularly in commercial real estate (CRE) and lower-end consumer credit. Investors, rating agencies, and depositors all reacted swiftly, leaving banks with squeezed margins, rating downgrades, and spiking bond spreads (**Figure 1**).

FIGURE 1

Large Regional Bank Spread Volatility Around 2023 Crisis



Source: Bloomberg

[1] Diversified US banks with $100 billion – $700 billion in total assets and Bloomberg Aggregate Bond Index eligible unsecured debt outstanding.

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As concerns grew, we took a cautious stance. While our exposure to regional banks was already limited, we saw enough signs of instability to justify reducing positions further. At the time, it wasn't just about the immediate fallout — it was about recalibrating for what looked like a protracted, if not permanent, impairment of credit quality for the sector.

WHAT THE MARKET FEARED — AND WHAT ACTUALLY HAPPENED

In mid-2023, the situation looked grim. Market expectations centered on steep recession risks, continued pressure on deposits and significant losses in CRE and consumer credit. Many feared these risks would lock regional banks into a cycle of declining profitability, eroding asset quality and tightening capital buffers.

Yet, as time elapsed, reality proved far less dire. Economic data surprised to the upside, easing recession fears, while consumers — bolstered by a resilient labor market — kept credit losses manageable. Even in CRE, where exposure seemed a looming threat, the losses failed to materialize at the scale expected, thanks in part to years of tighter underwriting standards. Deposits continued shifting into higher-yield accounts, but banks managed this headwind by reinvesting maturing assets at today's much higher yields.

By late 2023, we began reassessing the sector. Spreads on regional bank debt had widened dramatically, reflecting the market's worst-case fears, even as fundamentals showed early signs of stabilization. We started selectively adding exposure, focusing on the highest-quality banks where downside risks appeared overestimated.

FROM FEAR TO OUTPERFORMANCE

Regional banks have come a long way since March 2023. Today, their capital levels have risen well above regulatory minimums, and their profitability is recovering as net interest margins stabilize. Consumer credit trends have returned to pre-pandemic levels, and banks are steadily reducing their exposure to CRE, which has helped mitigate long-term risks. Spreads on regional bank bonds, which had widened significantly in 2023, have since outperformed, reflecting the market's acknowledgment of these improvements.

The broader economic backdrop has aided this recovery. The Fed's rate hikes, while initially destabilizing, have created opportunities for banks to roll off low-yielding assets and reinvest in higher-yielding instruments. As **Figure 2** shows, credit spreads have rebounded strongly, supported by robust earnings and optimistic outlooks for 2025. Looking ahead, the prospect of rate cuts could further bolster profitability, giving banks additional breathing room to solidify their balance sheets.

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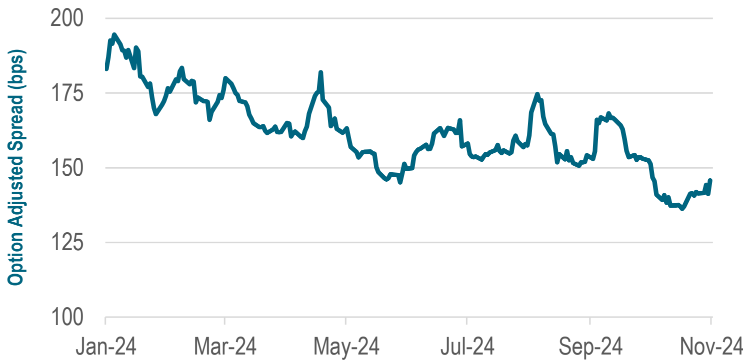
FIGURE 2

Large Regional Bank Spreads Rebound in 2024



Source: Bloomberg

OUR VIEW AND POSITIONING

While the scars of 2023 are still visible, we believe regional banks are on a solid path to recovery. Starting in late 2023, we gradually rebuilt our exposure. Throughout 2024, we pushed further, overweighting the sector by focusing on institutions with strong capital levels and asset quality, providing them the ability to navigate the evolving landscape. Even with spreads tightening, we continue to find opportunities among banks that were disproportionately punished during last year's turmoil.

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