



Angel Oak's Pate: End Of The Rate-Hike Cycle Will Pay Off For Banks In '23

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Cheryl Pate, senior portfolio manager for Angel Oak Capital, manager of the Angel Oak Financial Strategies Income Term Trust. Read the Q&A below as Cheryl says that it's late in the cycle for rate hikes, mid-cycle for banks in terms of margin expansion, and early in the cycle for credit, and she noted that the financial services sector typically goes through a profit-margin expansion that's a 'lagged benefit' that should show up early in the year when the rate hikes stop. She expects that benefit to show up late in the year or into 2024, but she says fundamentals – including credit quality and default risk – will be moving in the right direction and that financial services companies will experience the benefits they historically get from operating in high-rate conditions.



Cheryl Pate

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CHUCK JAFFE: Cheryl Pate, senior portfolio manager at Angel Oak Capital is here, and we're talking about how markets are impacting the financial services industry now on The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator's

going to point you in the right direction. And today it's pointing us towards portfolio manager Cheryl Pate from Angel Oak Capital, she runs the Angel Oak Financial Strategies Income Term Trust, that's ticker symbol FINS, and the Angel Oak Financials Income Impact Fund which is ANFIX. You can learn more about her and the firm at Angel Oak Capital and on Twitter @AngelOakCap. If you're looking to learn more about closed-end funds, interval funds, and business-development companies, make sure you check out AICAlliance.org, the website for the Active Investment Company Alliance. Cheryl Pate, welcome back to The NAVigator.

CHERYL PATE: Hey Chuck, thanks for having me.

CHUCK JAFFE: You and I last saw each other in the fall at the Active Investment Company Alliance's Fall BootCamp in New York, and you know, there's been a few things that have happened since then. There's been a little bit more clarity in terms of I think where people think rates are going. So give us an update, because we're at a spot where everybody's watching the Fed, but everything, whether the Fed moves or doesn't, trickles down to financial services.

CHERYL PATE: That's right, and the way we characterize it as to how the current cycle impacts where we are in financial services, and banks more specifically, we sort of characterize it as we're very late in the cycle for the Fed rate hikes, we're mid-cycle for the banks in terms of their margin expansion, and we're early cycle in terms of credit. And the way we're thinking about that is we still have a lagged benefit that comes through in terms of margin expansion for the financial services sector as we get to the end stages of the rate hikes, a couple more to come, maybe we're done at the end of the first quarter, but we haven't really started to see any cracks in credit outside of some episodic instances on the subprime credit consumer.

CHUCK JAFFE: If we haven't seen those cracks, when do they show up? Or do they not show up?

CHERYL PATE: I think this is a different cycle than what we have seen historically. As we're coming into the cycle you have consumers that have had a lot of stimulus over the last couple of years, a lot of payments related to the Covid pandemic, and higher savings rates than we have entered other cycles, we also have a strong jobs market. The question I think really is when do those impacts start to turn? And we start to see some of this I think firstly in areas like credit card lending and auto lending, and delinquency rates will start to normalize from

here. We're still at a part in the cycle where credit costs are lower than 2019, before we entered the pandemic, so there's a lot of room for normalization. I think we're going to start to see that maybe in the next couple of months or so, but I think it is going to be more of a back half of 2023 event and into '24.

CHUCK JAFFE: Do you worry at all about credit quality? Obviously higher rates typically mean more defaults, but a lot of the experts I've talked to have been saying that they think that defaults have been priced into an extent that we'll never see. In other words, there's a nice cushion there if you're buying the financials, because the financials are priced for a problem that they don't think is going to happen.

CHERYL PATE: I would say we always worry about credit quality, that's the number one focus on what could change our view on the sector in general. But I think you're right, when we look at how the banks are positioned today, strong liquidity, strong credit quality, a lot has changed in the last decade plus since the Financial Crisis, and we're looking at historically low credit losses today but reserves that are higher than any level going back to probably 2013. You've got a lot of liquidity still in the system, loan to deposit ratios are near historic lows, there's a lot of leverage that has been taken out and cash as a percent of earning assets is above pre-Covid averages too. So the banks have really strengthened their balance sheets in a lot of different ways, as well as de-risking the type of lending they do, so I do agree that we will see credit normalization. I don't think we're in for anything like a Financial Crisis-type event, and we don't expect severities to be anywhere in that magnitude, and probably lower than other cycles for the reasons I highlighted.

CHUCK JAFFE: Do you also think that banks specifically, but financial services companies in general, will kind of be the weird beneficiary of everything we've got going on? I mean, we have this odd thing right now, where if inflation starts to recede, if the Fed does whatever hikes it's got left to do, but then just kind of holds things steady and we start to see inflation go closer to the target, you're going to have a situation where reasonably high yielding stuff, relative to what anybody could get on a banking product, is now going to be out there doing better than inflation at a time when investors are scared of the market. Does that mean that we're going to wind up seeing some sort of cycle where consumers, if they're saving, they're going to be saving to banks, and banks will be the beneficiaries of having that cash rather than having them put it into the market?

CHERYL PATE: It will be interesting to see, I guess number one, how quickly we move back towards target inflation levels. But then if we are near the end of the hike cycle and we manage to skirt a recession or a more severe recession, I think that's more than priced into the market here and we could see certainly benefits to de-levered parts of the market, we could see again some of these deposit outflows that have gone into areas like treasuries flow back to the banks. And so I think the picture looking forward, particularly in that type of scenario where we're in a soft landing, is particularly beneficial for the banking sector and financial services more broadly.

CHUCK JAFFE: Which brings me to an interesting question; a year ago at this time we didn't realize that the market had already peaked, but if you had been looking ahead, and had been as most forecaster were, wrong, about the breadth of the market decline, you still would not have been surprised if somebody had forecast, "Hey, financial services is going to struggle in 2022." Well, this year people are a little bit more sanguine about where the market is. Last year they were more optimistic, some of that's been beaten out of them. But we've been through a year where pretty much every sector but one, energy, wound up being down last year. Financial services is one that's been identified by a number of people I've talked to as a place that might turn around. So if you and I talk again a year from now, will we be looking back and going, "Hey, financial services was one of the places to be in these tough times"?

CHERYL PATE: Absolutely. When you look historically at how financial services, diversified financials, whatever sector code we want to drill down on, those are the areas that benefit from higher rates, and there is a lagged impact as to when those higher rates flow through into the lending products for example. A lot of loans are tied to floating rates but it could be a quarter or two lagged impact, so a lot of that is still to come on the first half of this year that I think is not being appreciated as much by the market as we feel it should be.

CHUCK JAFFE: Well Cheryl, this has been great, I hope we have that conversation down the line, see how it all plays out. Thank you so much for joining me on The NAVigator.

CHERYL PATE: Thank you.

CHUCK JAFFE: Thanks everybody for joining us on The NAVigator, which is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffee. And yes, that's me, and you can check out my hour-long weekday show on MoneyLifeShow.com or wherever you get the good podcasts. To learn more about interval funds, closed-end funds, and

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