Investment Note

14 June 2018

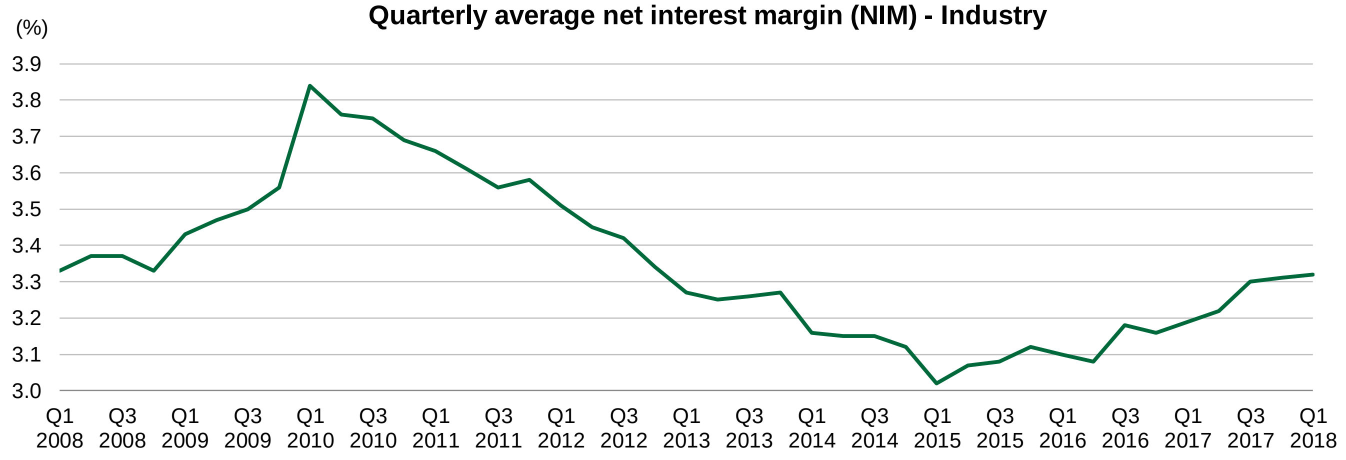
Higher interest rates positive for US bank equities

On 13 June 2018 (US time), the Federal Reserve (Fed) raised interest rates by 25 basis points (bps) to a range of 1.75%-2.00%.[1] In this investment note, the Portfolio Managers of Bank Opportunities and Financial Industries Strategies view higher interest rates in the US as positive for US bank equities, particularly small and mid-cap banks. Overall, rising interest rates should help increase banks' net interest margins, leading to higher revenue and earnings.

Banks' net interest margins on the rise

The Fed's widely expected decision to raise interest rates on Wednesday may be followed by further rate hikes this year. The midpoint projection in the federal funds rate dot-plot increased a quarter point to 2.4% for the end of 2018.[2] This implies a total of four rate increases in 2018. Its press release cited a fairly upbeat assessment of the economy with a healthy job market, an increase in household spending, and strong business investment growth. We expect a measured pace of rate normalisation and we could see at least one additional rate increase in 2018 and two more in 2019. Overall, we believe the Fed's current monetary policy will continue to be beneficial for the banking sector. As the Fed started to increase interest rates this cycle, loan rates have moved higher at a faster pace than deposit rates, leading to improving net interest margins (NIM) and higher net interest income for US banks (see Chart 1). Indeed, the trend of rising NIMs has been a key driver of higher earnings growth for the industry.

Chart 1: Net Interest Margin of US Banks[3]



[1] Source: Federal Reserve: FOMC statement, 13 June 2018.
[2] Source: Federal Reserve: "Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents under their individual assessments of projected appropriate monetary policy", June 2018.
[3] Source: Federal Deposit Insurance Corporation, as of 22 May 2018.

Majority of small- and mid-cap banks' revenues are from spread income

In general, small- and mid-cap banks generate more of their revenue from spread income than larger banks; between 70% and 80% of their revenues come from spread income. Large-cap banks usually have more diverse revenue streams, e.g. investment banking, capital markets, asset management, and therefore tend to get less of their revenue from spread income, although it is usually still more than 50%.

We believe both groups of banks will see increasing NIMs in the rising rate environment. Over time the level of benefit will likely decrease with each subsequent rate hike as deposit costs eventually start to increase at the same pace as loan rates. However, so far deposit rates have not adjusted as fast this cycle due, in part, to still low absolute level of rates and lower than average loan-to-deposit ratios.

Balance sheet composition differs for each bank

The impact of rising rates on an individual bank's NIM will depend on the duration and composition of the specific assets (loans and securities) and liabilities (non-interest, interest-bearing deposits, and other funding sources). We believe it is vital to understand the composition of each bank's balance sheet and examine their disclosures on interest rate risk, and discuss interest rate sensitivity with bank management teams, to understand the impact of different interest rate environments on the specific bank's NIM.

Therefore, it is important to be selective on which banks to own in a rising rate environment, and we emphasise those that should be better-positioned to benefit from this cyclical tailwind. In addition, we look for banks that will benefit from longer-term secular themes – including a more favorable regulatory environment and increased merger & acquisition activity – when managing our portfolio. Further, valuations are attractive both on a price/book and price/earnings perspective compared to historical averages. Against this backdrop, we view this as an opportune time to be investing in the sector.