US banks

Rising rates are not all good news for US banks

Increasing deposit costs could squeeze profit margins for lenders

Robert Armstrong in New York AN HOUR AGO

This week's jump in interest rates has carried bank stocks along with it, but investment analysts caution against assuming that a rising rate environment will boost bank earnings, particularly in the near term.

The reason: what banks pay for deposit funding — which has been close to nothing, in many cases, for several years — may increase faster in the months to come than what banks can earn by lending out those deposits.

"The sensitivity of loan yields to higher rates is declining," said Charles Peabody of Portales Partners. "You are getting less bang for your buck."

Wednesday's 11 basis point hop in the 10-year Treasury yield, to 3.16 per cent, was the biggest in almost two years. Banks stocks have followed rates higher. In the last three days, the S&P 500 bank index has climbed 2 per cent. Bank of America, considered the most rate sensitive of the big banks, rose 2.6 per cent.

Banks like having very low deposit rates, but they can't have that forever

Geoffrey Elliott of Autonomous Research

A rising 10-year yield is often seen as good for bank stocks because higher long-term rates tend to create a steeper yield curve — that is, a bigger gap between short-term and long-term rates. This means wider profit margins for banks as the spread between what they pay for funds and what they can charge for them grows.

The spread between the US two-year and 10-year Treasury yields widened by 5 basis points, to 31bp, between mid-day Wednesday and the close of trading on Thursday. It hit 18bp, the lowest since 2007, in mid-August.

Data gathered by Mr Peabody show that between the Fed's first rate increase at the end of 2015 and the end of 2017, loan yields at large US banks rose more than deposit rates. While the Fed funds rate rose by 1.75 percentage points, average loan yields rose 1.12 percentage points, and deposit rates by 0.87 percentage points.

In the first two quarters of this year, the relationship reversed. The 0.5 percentage increase delivered by the Fed corresponded to a 32bp increase in loan yields and a 35bp increase in deposit rates.

Deposit costs can rise quickly, and the fact that many US banks are advertising savings account and certificates of deposit paying more than 2 per cent suggests that is just what is happening.

“Banks like having very low deposit rates, but they can’t have that forever,” said Geoffrey Elliott of Autonomous Research. He said he sees more banks’ deposits shifting from non-interest bearing accounts to interest-bearing ones. And at the 14 online lenders he tracks, savings account rates have risen from an average of 1.2 percentage points to 1.8 per cent in the past year.

Mr Peabody said he thinks investors are in for a surprise when the banks report third-quarter earnings. “Margins and loan volumes are going to prove a disappointment for a number of banks, and for the rest, forward guidance will be much more cautious than it has been.”

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Other analysts emphasised that, while rising rates might herald higher costs, they can also signal coming economic strength.

“The yield curve steepening sends a positive message about the economy for the next few years” said Mr Elliott, “and a flat curve has been a concern for long-term investors for a number of years.” Portfolio managers hesitate to own economically sensitive bank shares when a flattening yield curve is predicting a recession.

Jeffery Harte of Sandler O’Neill said he has been surprised that US loan growth has not been stronger, given the robust economy. “It’s nice to see the long end [long-term rates] go up,” he said, because it implies activity is picking up.

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