Mitch on the Markets

Who wins with Fed interest rate hikes?

By Mitch Zacks
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The Federal Reserve's decision to raise interest rates at the December 18-19 meeting last year was a source of contention for the equity markets. In fact, just about every rate increase last year (four total) was met with short-term volatility – a reckoning that the era of easy money was officially coming to a close.

I've argued many times in many columns that I do not believe the Fed has committed any monetary policy errors *to date*. When the U.S. economy is growing at a firm clip, S&P 500 earnings are rising near +20%, and the unemployment rate is near a 50-year low, what do we really expect the Fed to do?

Higher interest rates are warranted – particularly since the Fed is moving the fed funds rate from historically low levels. The idea that moving the fed funds rate to a ~3% neutral rate is somehow disruptive and dangerous is misguided, in my view. Think about it like a parent taking away their child's allowance once they become a senior in college. Three years in college is surely enough to possess the skills needed and the strong foundation to keep growing. The U.S. economy is the same way. Time to remove the punchbowl.

For all the fear of rising rates, there's one sector that has benefited significantly in the near-term as a result: Financials.

In short, higher rates mean banks can charge more for loans. The difference between what banks pay to customers for deposits and what they charge borrowers for loans is known as the banks' net interest margin. Higher net interest margins mean higher profits.

Banks have been benefiting from higher rates because they've been quicker to raise rates for loans than they have been to raise rates for deposits. An unfortunately reality here is that what's good for shareholders isn't necessarily great for borrowers and depositors.

The average yield on savings accounts has held steady at 0.09% since January 2018, while average credit-card rates have gone up 1.09% to 17.41%

(according to Bankrate.com). At JPMorgan, for example, the average interest rate on its loan book in Q4 rose 0.59% to 5.26%, while the average rate on its interest-bearing deposits ticked up a much lesser 0.37%, to 0.72%.[1] In this example, its net interest margin increased by about 20 basis points.

Improvement in banks' consumer units has shown up in Q4 earnings reports. Bank of America posted profit and revenue numbers that exceeded the street's expectations, with profits in their consumer banking business jumping 52% to $3.3 billion. In JP Morgan's consumer unit, profit was even higher at $4.03 billion, which marked a similar 53% increase. Goldman Sachs saw its investing and lending division generate $1.91 billion in revenue, which was about $550 million more than analysts expected.[3] Similar stories played out at other major banks, like Wells Fargo and First Republic.

Bottom Line for Investors: Eye the Yield Curve

At the end of Q4, the yield spread – as measured by the difference between 2-Year and 10-Year Treasury bonds – was at +0.19%, down from +0.24% at the end of September and at the tightest level seen since 2007.[3] While a flattening yield curve is usually associated with an economy that is slowing down or possibly entering a recessionary phase – and it could mean squeezed profits for Financials – it's also at odds with a U.S. economy that is expected to grow at a rate above 2% and an unemployment rate that remains at historically low levels.

Banks are enjoying a moment of higher net interest margins for now, but as the yield curve continues to flatten, those margins will eventually get squeezed. Investors should actively monitor the yield curve as a mechanism for determining portfolio weightings to the Financials sector.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] The Wall Street Journal, January 15, 2019. https://www.wsj.com/articles/big-banks-find-sweet-spot-in-higher-rates-11547582951
[2] CNBC, January 17, 2019. https://www.cnbc.com/2019/01/17/the-major-bank-earnings-reports-are-all-in-and-morgan-stanley-was-the-biggest-loser.html
[3] U.S. Department of the Treasury, January 22, 2019. https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/textview.aspx?data=yield

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