Mitch on the Markets

High-performing bank stocks defy flat yield curve

By Mitch Zacks
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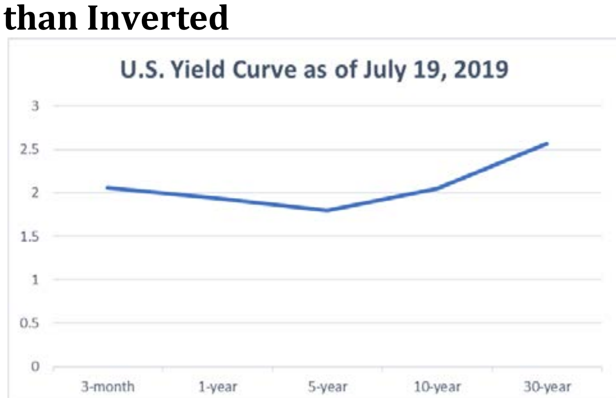
Low interest rates coupled with a flat yield curve usually mean bank profits will come under pressure. Generally speaking, the flatter the yield curve, the lower a bank's net interest margins – which is the difference between what a bank earns on loans versus what it pays out in interest on deposits. J.P. Morgan saw its net interest margin fall to 2.49% in the second quarter (from 2.57% in Q1), while Wells Fargo's fell from 2.91% to 2.82%.[1] For banks, these represent paltry margins.

The Yield Curve is More "U-Shaped" than Inverted



Source: U.S. Department of the Treasury[2]

Yet in the second quarter, Financials were the best performing sector. Financial stocks delivered nearly double the return of the S&P 500 in Q2, climbing +8.0% versus the S&P 500's +4.3%. How and why did bank stocks do so well?[3]

The answer can be found by taking a closer look at the divergence between consumer confidence and business confidence in the current U.S. economic climate. While consumers are growing increasingly confident and enjoying the tailwinds of a modestly strong economy, businesses are growing increasingly concerned about how much longer the business cycle may last.

Let's start with the consumer. The United States currently has near record low unemployment, low interest rates, wages modestly on the rise, and a stock market near all-time highs. In the mind of the consumer, times are good. High confidence and low interest rates often lead to more spending and borrowing, which is helping prop up bank profits.

Indeed, banks that cater to the Main Street consumer have been enjoying a surge in profits in consumer lending divisions. Banks like J.P. Morgan, Wells Fargo, and Citigroup – which all have large lending and credit businesses –

saw profits climb in the second quarter. At J.P. Morgan, credit card spending climbed 11% to $192.5 billion in the second quarter, while outstanding credit balances jumped 8% to $157.6 billion. J.P. Morgan enjoys status as the largest U.S. lender by assets, but Citigroup and Wells Fargo also felt the boost. Purchase volume at Citi rose 8% in Q2 while balances rose 6% at Wells. Mortgage origination and refinancing was also higher at all three banks in Q2, as the rate on a 30-year fixed mortgage fell below 4%.

Note: whether or not rising credit balances and new/refinanced mortgages is a good trend for consumers is another story for another day, but in the meantime, banks have been feeling the profitable effects.

Meanwhile, banks with smaller consumer credit and lending divisions, like Goldman Sachs, saw profits fall in the second quarter. Goldman was the only U.S. bank to report lower profit in Q2 versus what it reported in Q1, with a 6% decline fueled by slower activity in trading, investment banking, and corporate debt issuance.

Herein lies the tale of two confidence measures. On the one hand, consumer confidence is high and rising on the heels of low unemployment and low interest rates. On the other, business confidence is mixed as global economic growth is seen slowing and as the U.S. and China continue apace with a trade dispute that has no tangible end in sight.

Where businesses are reluctant to borrow and invest in expansion and growth, consumers feel confident enough to keep spending and running-up credit balances. The key question is whether banks' reduction in business lending is due to lower confidence or to a lack of investment opportunity. But it may also be a byproduct of sinking demand – publicly traded corporations have been borrowing heavily in debt markets largely to buy-back stock, which would seem to indicate the issue is a lack of investment opportunities.

Goldman Sachs has responded to this new dynamic by pivoting to cater to Main Street consumers, rolling out a personal loan and consumer banking division known as Marcus. But the investment bank has a lot of ground to make up to compete with the likes of Bank of America, J.P. Morgan, Citigroup, and Wells Fargo.[4]

Bottom Line for Investors

Banks are adapting to an environment where "smaller fish" are a better source of profits than the larger deals that hinge on activities like debt trading, corporate lending, and investment banking. At the end of the day, from a macro perspective, this dynamic is being driven by lower global investment opportunities available to corporations. Effectively, I see a global oversupply of money available for lending, which drives down interest rates.

For investors, this means Financials should not be dramatically underweighted relative to benchmarks. Ultimately, consumer-focused lending likely has some room to run. However, how bank stocks perform is likely to be driven by whether the yield curve continues to invert. My best estimate, based on leading economic indicators, is that the yield curve will normalize but at a lower slope than we've seen historically.

About Mitch Zacks

Mitch is the CEO & Senior 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, July 16, 2019. https://www.wsj.com/articles/consumer-lending-powers-big-bank-earnings-upstaging-wall-street-11563301446?mod=djem10point
[2] U.S. Department of the Treasury, July 22, 2019. https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield
[3] S&P 500 Total Return. Strategas Quarterly Review in Charts, July 1, 2019.
[4] The Wall Street Journal, July 16, 2019. https://www.wsj.com/articles/consumer-lending-powers-big-bank-earnings-upstaging-wall-street-11563301446?mod=djem10point