Manulife Asset Management

Investment Note

22 March 2018

Twin catalysts for US bank equities: Rising interest rates and reforms

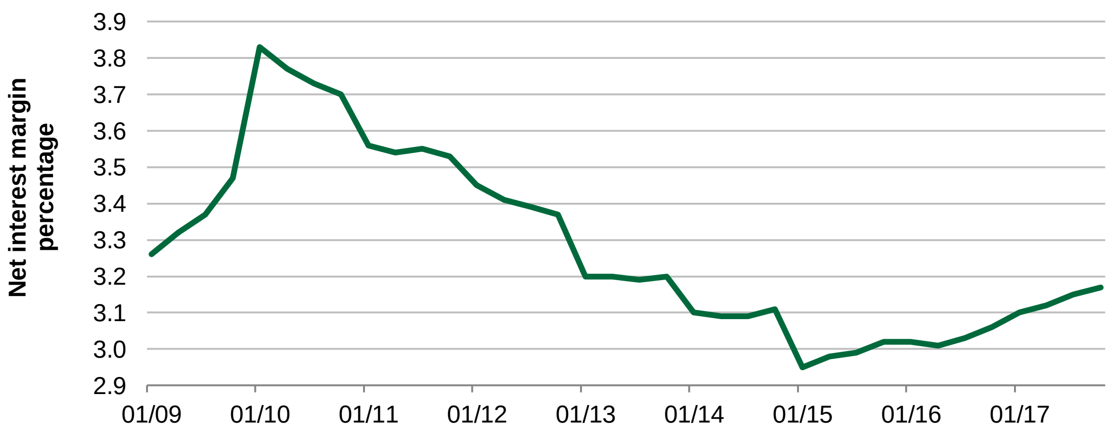
The Federal Reserve's pace of interest rate hikes has raised questions of its impact on the banking sector. At the same time, numerous financial sector deregulation initiatives have been introduced and passed. The Portfolio Managers of Bank Opportunities and Financial Industries Strategies view these developments as twin catalysts for US bank equities in 2018, particularly small and mid-cap banks. Rising interest rates should increase banks' net interest margins, revenue and earnings, while reforms (deregulation and tax reform) should lower banks' operating costs and tax burden to boost earnings prospects.

Rising interest rate environment positive for banks' net interest margins

We believe the Federal Reserve (Fed's) current interest rate hiking cycle will be beneficial for the banking sector. Indeed, since the Fed started interest rate normalization in December 2015, banks have benefitted from a trend of rising net interest margins (NIM) (see Chart 1) – NIM is the difference between banks' interest income and interest expense as a percentage of average earning assets.

The dynamics of NIM will change along with higher rates. Currently, retail deposit interest rates have remained low thus far in the cycle, although we expect a higher deposit rate along with increasing rates. However, we believe that NIM will still increase in 2018: banks should receive a higher percentage increase on loan rates or asset yields than that paid on deposits. This trend should continue as we think the Fed will raise interest rates at least twice more this year.

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



[1] Federal Reserve Bank of St. Louis, as of October 2017.

We are closely monitoring the impact of higher interest rates on the key drivers of bank fundamentals, including loan growth. We believe that the absolute level of rates, from a historical perspective, remains low enough to not have a negative impact on future loan growth. We believe loan growth could accelerate in 2018 from the 3-4% range the industry experienced in 2017, due to certainty around tax reform, the tax law change that allows immediate expensing of capital investments and the potential for a faster growing US economy. In particular, we expect an acceleration in commercial loan growth as commercial companies undertake capital investment projects throughout the year.

Regulatory and tax reform spur lower costs and higher profits

We have also seen positive developments on the regulatory front. On 14 March, the US passed revisions to the Dodd–Frank Wall Street Reform and Consumer Protection Act.[2] The revised version now moves to the US House of Representatives for a vote.[3] One of the bill's main revisions would raise the threshold for Systemically Important Financial Institutions (SIFI) from US$50 billion or more in total assets to US$250 billion. Small regional banks would particularly benefit from this change, as they would no longer be subject to onerous annual stress tests, potentially lowering their compliance costs and increasing the likelihood to return capital to shareholders. If the bill ultimately passes, we envisage accelerated M&A activity in the regional space, as banks seek to leverage economies of scale.

We also hold a constructive view on the impact of tax reform on banks. The Tax Cuts and Jobs Acts of 2017 reduced the statutory corporate tax rate in the US from 35% to 21%. The banking sector is well positioned to benefit from lower tax rates as the industry pays, on average, a 30% effective tax rate[4]. Indeed, we expect that earnings will now grow, on average, 25% in 2018 (versus 10% without tax reform) for the average US bank after factoring in tax reform,[5] as well as result in improved return on assets and return on equity for banks.

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[2] Financial Times, "US regional banks powered by prospect of sector reforms", 14 March 2018.
[3] Financial Times, "House Republicans push for more sweeping bank deregulation", 15 March 2018.
[4] NYU-Stern research.
[5] Manulife Asset Management estimates, 22 March 2018.

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