NASHVILLE NOTES

Rate hikes are a plus for banks, with an asterisk

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Banks just wrapped up a fantastic quarter in which the stars aligned for Wall Street business units, credit and net interest margins. Loan growth just OK, but rapid loan growth consumes capital, so the torrent of capital returns to shareholders continues.

JPMorgan Chase & Co. CEO Jamie Dimon described the quarter as "getting close to as good as it gets," but said when it ends is anyone's guess

Dimon and his peers got solid reviews for the quarter. Federal Reserve Chairman Kevin Warsh, on the other hand, was mostly panned by Street and the financial press based upon his press conference performance after the Fed declined to raise policy rates, with dissents from three of 12 F Open Market Committee voters.

If the Fed is committed to achieving its 2% inflation target rather than the current rate around 3% — that is, halving the purchasing power of a c roughly 36 years rather than 24 years, per the Rule of 72 — then why not hike now? I think the obvious reason is that the heavily indebted fede government, which is running annual deficits of around $2 trillion, cannot afford it. Plus, hikes would pressure many emerging market economi raise rates to defend their currencies when they are struggling with elevated energy prices.

As an aside, I once asked then-Federal Reserve Bank of St. Louis President James Bullard at a forum in 2017 why the Fed did not target an infl rate of 0% to preserve the value of a dollar. To his credit, he offered that 0% or 1% might be the right number, but said the Fed believed 2% was appropriate. He then quickly took the next question. At the time of the comment, the Federal government's debt was about $20 trillion, compare roughly $40 trillion today.

> ***I doubt the Fed will be able to hike rates aggressively if inflation breaks to the upside, so I think the yield curve for now will favor banks. I am less optimistic about deposit pricing.***

Assuming the Fed eventually acts, rate hikes will be good for most commercial banks, with two important caveats as asset yields move higher i uneven fashion, depending upon asset mix and repricing characteristics.

One is that the yield curve remains positively sloped by a notable amount, particularly between short-term bills and five-year notes. The second deposit betas remain well below 1.0. Unlike in 2022 and 2023, I doubt the Fed will be able to hike rates aggressively if inflation breaks to the u so I think the yield curve for now will favor banks. I am less optimistic about deposit pricing.

Unlike in early 2022, when banks entered the year with extraordinary liquidity, that is not the starting point today. Much of the excess liquidity the system, loan-to-deposit ratios have risen, deposit competition is intense and depositors have been trained to pay attention to yield. A new hi cycle might resemble a late-cycle dynamic in which deposit rates move nearly basis point-for-basis point with market rates.

Another implication is greater pressure on low-coupon bond portfolios. Arguably, the damage to bond values from rising rates in the past six m has been done — unless market-driven rates move even higher. Typically, yields on intermediate- and long-term bonds stabilize or ease once th begins to hike. Bigger unrealized losses are not a foregone conclusion, but the cost to carry underwater portfolios will increase. The pain will n intense as it was toward the end of 2023 when portfolio yields were lower, but it will persist.

> ***In a higher-rate environment, the quality of the deposit franchise becomes increasingly important — not merely the reported cost of deposits in the latest quarter.***

Wall Street will intensify its focus on these factors if and when the Fed catches up with the bond market, but there is an important strategic poin may be overlooked and gets little attention in quarterly earnings releases: Non-interest-bearing deposits become more valuable when rates rise.

I may have missed it, but I did not hear anyone give Dimon an "attaboy" for the 6% increase in average non-interest-bearing deposits in the sec quarter compared to the year-ago quarter. The increase lagged the 11% increase in average earning assets, but the funding is not insignificant at earning assets.

In a higher-rate environment, the quality of the deposit franchise becomes increasingly important — not merely the reported cost of deposits in latest quarter. Banks with deep commercial relationships, meaningful operating accounts and great liquidity management should possess a struc funding advantage.

Multiple Fed hikes can be disruptive and cause valuations to compress — as occurred in the last hiking cycle — but banks with great deposit franchises that are anchored with robust non-interest deposit pricing may be the best candidates for rising earnings estimates and better-perform stocks.

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