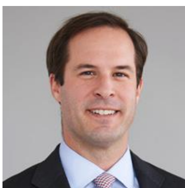
RETURN OF LOAN GROWTH SHOULD BOOST SELECT BANKS IN THE U.S.



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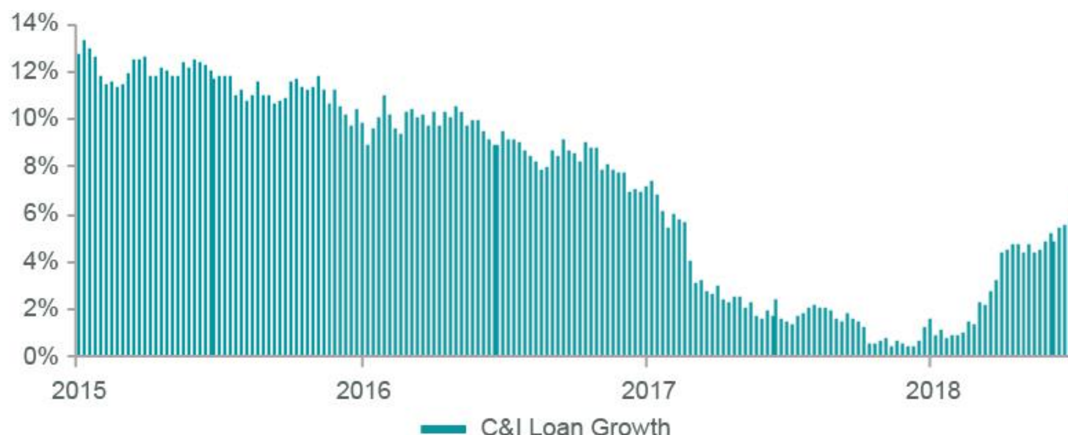
Key Takeaways

- Commercial and industrial (C&I) loan growth is gaining momentum, a positive sign for U.S. banks.
- With deposits becoming more expensive, funding profitable growth is a key risk to the U.S. banking sector that will differentiate bank stock performance.
- Deposit-rich banks will likely be able to partially avert an increase in deposit costs that will accompany rising interest rates and more fully take advantage of C&I loan growth.

After a period of subpar lending activity as businesses awaited clarity on tax and other government policy, commercial and industrial (C&I) loan growth has been gaining momentum in 2018, moving from a growth rate below 1% in January to above 6% in July, the highest loan growth rate in over a year (Exhibit 1). This is a positive sign for banks in the U.S. for several reasons. C&I loans, which finance capital expenditures and provide working capital to businesses, are a key indicator of business activity. As the second-largest loan category for U.S. banks next to real estate, C&I loans are also a meaningful contributor to industry-wide loan growth. We believe C&I loan growth is a key driver for sustainable organic earnings growth for banks, and a more valuable contributor to growth than the environmental impact of rising interest rates. C&I loans also tend to price with reference to short-term Libor or the prime rate, so they will reprice higher (generating more interest income) should the Federal Reserve (Fed) continue raising interest rates. An increase in C&I loan activity, therefore, keeps us generally positive on the outlook for U.S. bank stocks.

Exhibit 1: U.S. C&I Loans: Year-over-Year Growth



As of 11 July 2018. Source: Federal Reserve, ClearBridge Investments.

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Exhibit 2: U.S. Deposit Growth is Slowing

As of 11 July 2018. Source: Federal Reserve, ClearBridge Investments.

Increased C&I loan activity is not the only reason to like bank stocks. Deregulation and rising interest rates have created a favorable environment for banks of late. Bank deregulation has increased the industry's capital flexibility, enabling incremental dividends and share buybacks. Since the financial crisis, capital return has been a source of value for shareholders of companies in other (non-financial) industries, while larger banks faced limitations on capital return. Banks should benefit from several recent regulatory developments, among them: the raising to US$250 billion from US$50 billion of the total asset threshold above which banks face stricter rules on capital and merger & acquisition (M&A); the possibility of less frequent or less strenuous comprehensive capital analysis and review (CCAR) stress tests, which would allow banks to do more with excess capital; and the appointment of private equity veteran Randy Quarles as Vice Chairman of Supervision to the Fed (Quarles favors a lighter regulatory scheme). Likewise, the Fed's slow and steady interest rate hikes, and the associated climb in bond yields, has been helping banks grow their net interest income and margins.

Deposit Growth May Pressure Some Banks

While we are positive on U.S. bank stocks in general, we believe the industry will increasingly become a stock picker's market. A tighter monetary environment is putting a strain on bank deposits (both Fed-driven deposit growth and deposit costs) that should make it more difficult for banks — some more than others — to profitably fund loan growth. In a rising deposit cost environment, banks that can attract and retain low-cost deposits to fund improving loan growth should separate themselves from the pack and outperform.

While C&I loan growth has risen of late, deposit growth has begun to trend downward (Exhibit 2). The slowing of deposit growth is noteworthy for two reasons. First, it could mean more sustained loan growth. Sustained C&I loan growth frequently comes at the expense of deposit growth (Exhibit 3), as C&I customers will often fund the initial leg of growth or capital expenditure by first drawing on excess deposits before taking on permanent financing in the form of debt.

We have seen this in the past: deposit growth in the U.S. decelerated meaningfully in the fall of 1981, the spring of 1988, between June 1993 and April 1994 and in the winter of 2010. For each decline there was at least a short-term increase in the growth rate of C&I loans — in the latter two cases this increase was dramatic (Exhibit 3).

Some of the slowing deposit growth could be explained by monetary policy normalization and the Fed draining reserves from the economy. This line of thinking would highlight how the Fed's quantitative easing program, in which it printed reserves for the banking system, expanded banks' balance sheets. Now, as the Fed ceases

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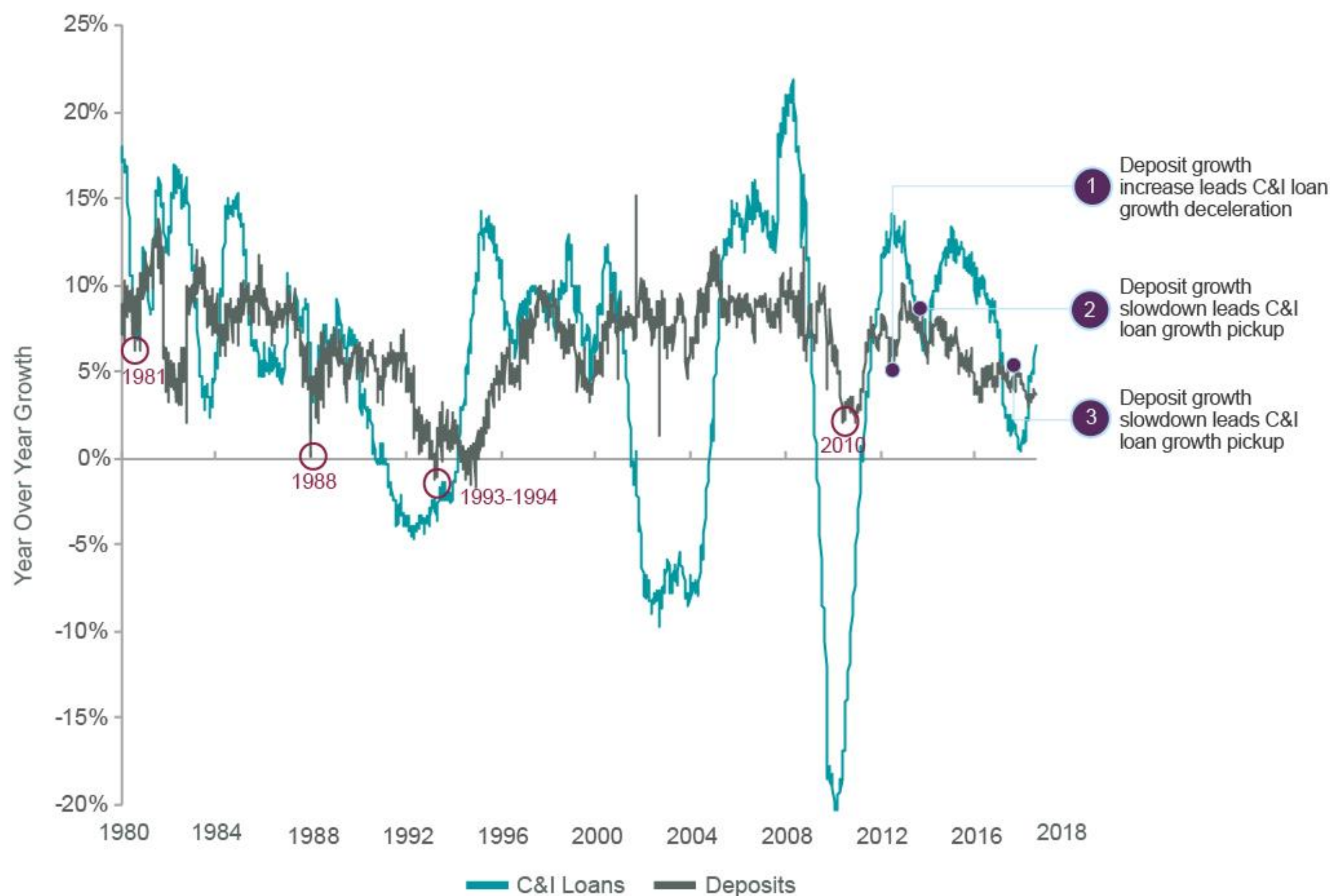
either to reinvest proceeds from maturing bonds or to print more money, bank deposits are comparatively less plentiful. But increased business investment likely has a large role, as capital spending plans have dramatically increased since the beginning of 2017 and enough confidence has returned to businesses to make real investments for the future (Exhibit 4).

Importantly, in addition to pointing toward sustained loan growth, slower deposit growth is noteworthy because it should be a source of differentiation among U.S. banks. As banks attempt to capitalize on improved loan demand, franchises with stronger deposits should face less funding cost pressure than those with weaker core deposits or stretched loan-to-deposit ratios and more effectively capitalize on the potential loan growth opportunity.

Bank Funding Profiles Will Be Key

As loan growth picks up and deposit growth slows, bank funding profiles will become increasingly important. Specifically, U.S. banks with high loan-to-deposit ratios (greater than 95%) may find their liabilities more sensitive to rising interest rates. These banks will have a choice: “pay up” for the deposit funding needed to support growth by raising the rate they pay on deposits as interest rates rise, or reduce loan growth expectations. “Paying up” will limit the potential net interest margin expansion from higher interest rates (the difference between their asset yield and liability costs). This pressure is no small concern, especially for regional banks that tend to run fully levered balance sheets (as measured by loan-to-deposit ratios of nearly 100%) with ambitious growth initiatives (Exhibit 5).

Exhibit 3: U.S. Deposit and C&I Loan Growth (1974 – Current)



As of 30 May 2018. Source: Federal Reserve, ClearBridge Investments.

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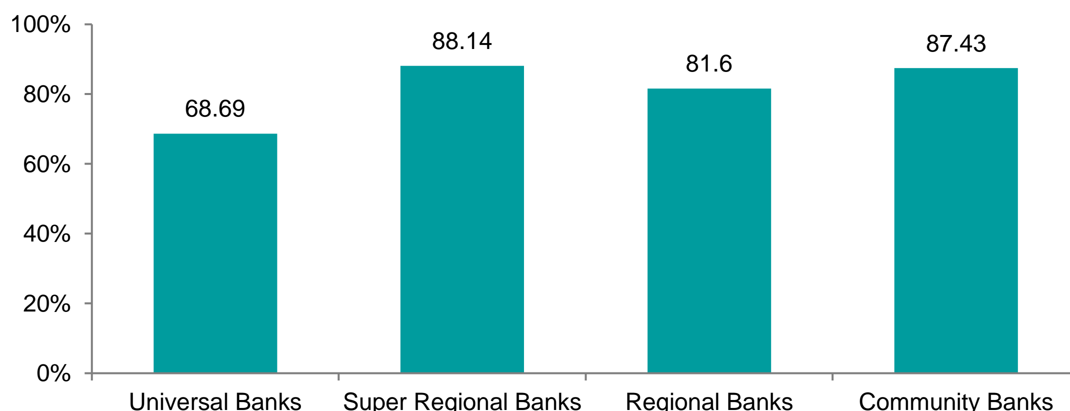
Exhibit 4: Philadelphia Fed Survey on Next 6 Months Capital Spending Plans

As of 1 March 2018. Source: Federal Reserve Economic Data (FRED). Future Capital Expenditures forecasts the change in capital expenditures over the next six months for reporting manufacturing firms. The diffusion index is calculated by taking the percent reporting increases and subtracting the percentage reporting decreases.

Slowing deposit growth in the U.S. should have the effect of separating bank stocks according to their funding profiles (Exhibit 6). Some of the small and mid-size banks that have recently looked attractive because cheap funding facilitated loan growth may now have a much harder time funding their growth attractively without the surplus of deposits provided by easy monetary policy. Larger banks, on the other hand, seem on average to have surplus funding (as measured by lower loan-to-deposit ratios). These deposit-rich enterprises should be able to continue to have lower deposit betas (i.e., their costs will rise comparatively less), and rising interest rates should benefit them disproportionately more.

The risk posed to some banks by scarcer and more expensive deposit funding may catch the market by surprise, as liabilities have not been a concern for bank investors for some time. After the Great Recession and up until the Fed began raising rates the environment for bank stocks in the U.S. was somewhat homogenous: deposits were plentiful and credit quality benign. Stock picking was less important than simply having exposure to the industry at large. Before the Great Recession, however, core deposit funding was a point of differentiation among banking franchises. As the period of monetary accommodation looks to be coming to an orderly close, many investors may have forgotten the risks banks faced when deposit competition accelerated. Going forward, we expect greater differentiation among bank stocks, and knowing the bank you've invested in will be more important than it has been for quite some time.

Exhibit 5: U.S. Bank Loan-to-Deposit Ratios



As of 31 December 2017. Source: Federal Reserve, ClearBridge Investments.

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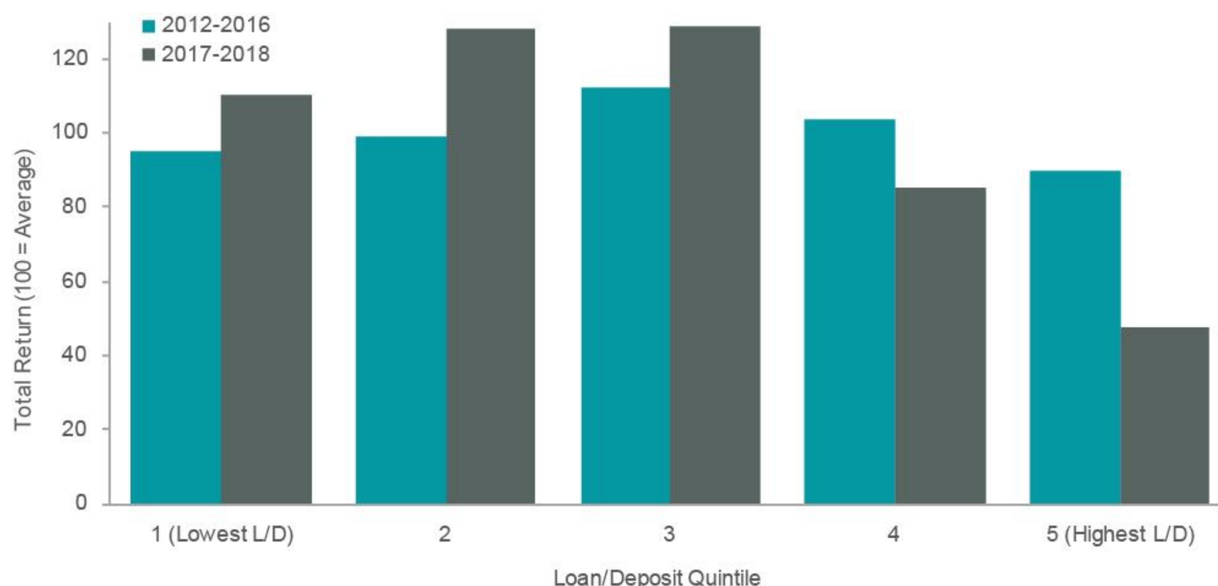
Exhibit 6: Recent Performance Skewed to Deposit-Rich Banks
When the bank has lower Loan/Deposit ratio, it is richer in deposit



As of 15 May 2018. Source: ClearBridge Investments, Bloomberg LP. Represents bank stocks in the Russell 3000 Index. L/D = Loan/Deposit.

Conclusion

We believe slowing deposit growth in the U.S. points to the possibility recent C&I loan growth is sustainable. We believe investors should focus on banks with moderate loan-to-deposit ratios (less than 90%) and attractive core deposit franchises. This cohort should be able to fund balance sheet growth at more attractive rates than more leveraged peers (or at least avert rising funding costs more). We also favor banks with a greater percentage of total loans in the C&I category: these banks will benefit from the recent improvement in C&I loan growth outlook. C&I loans also tend to price with reference to a short-term Libor or prime rate, so they should generate more interest income in a rising rate environment. U.S. banks with enough deposits to weather rising rates while funding loan growth look poised to stand out as the era of easy money comes to an end.

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