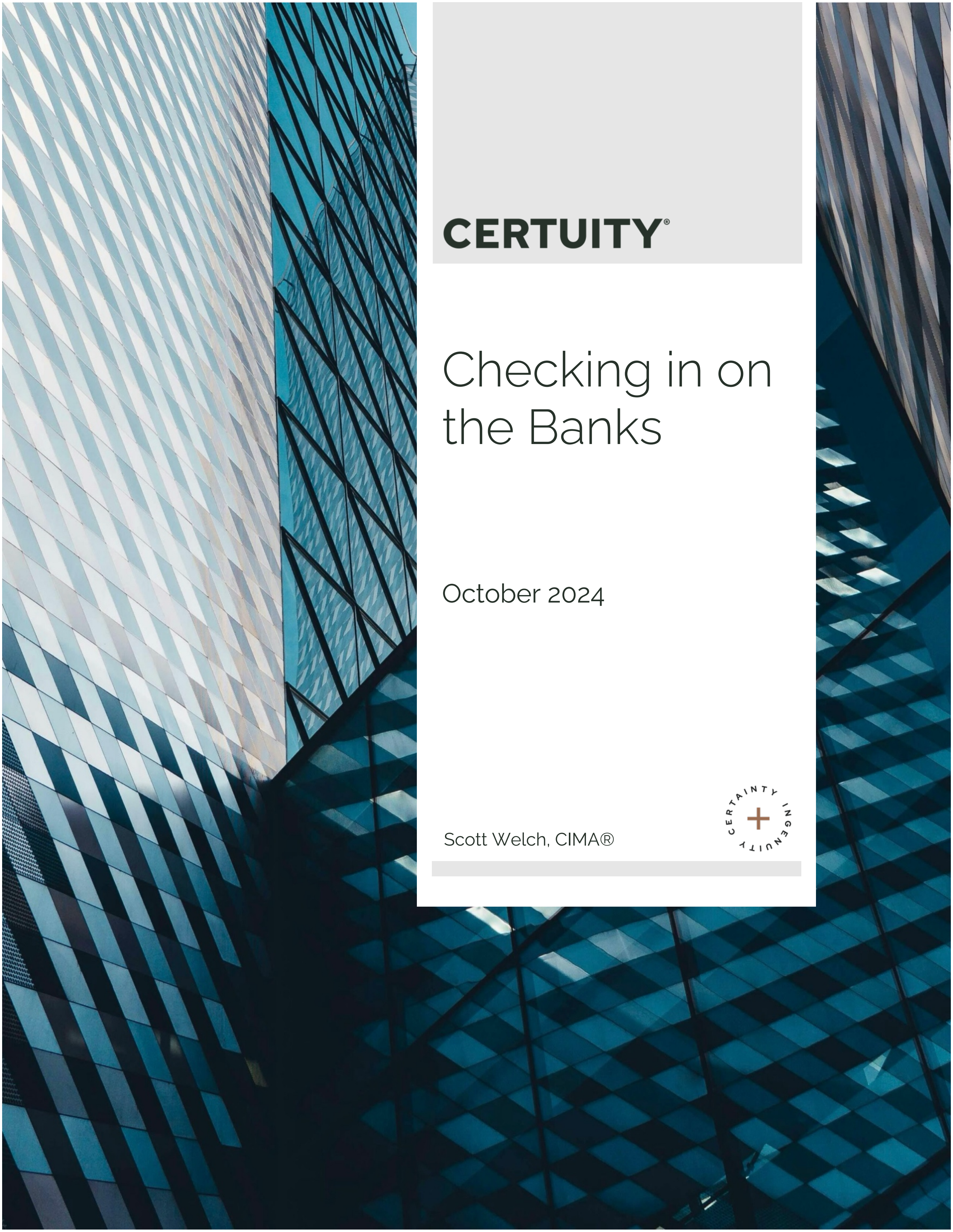


CERTUITY®

Checking in on the Banks

October 2024

Scott Welch, CIMA®

> *"My name is Tom Cranker and I'm a jolly banker…*
> *If you show me you need it, I'll let you have credit…*
> *Just bring me back two for the one I lent you…"*
>
> - (WOODY GUTHRIE, 1940)

Let's begin by emphasizing we are not bank analysts, nor sector specialists.

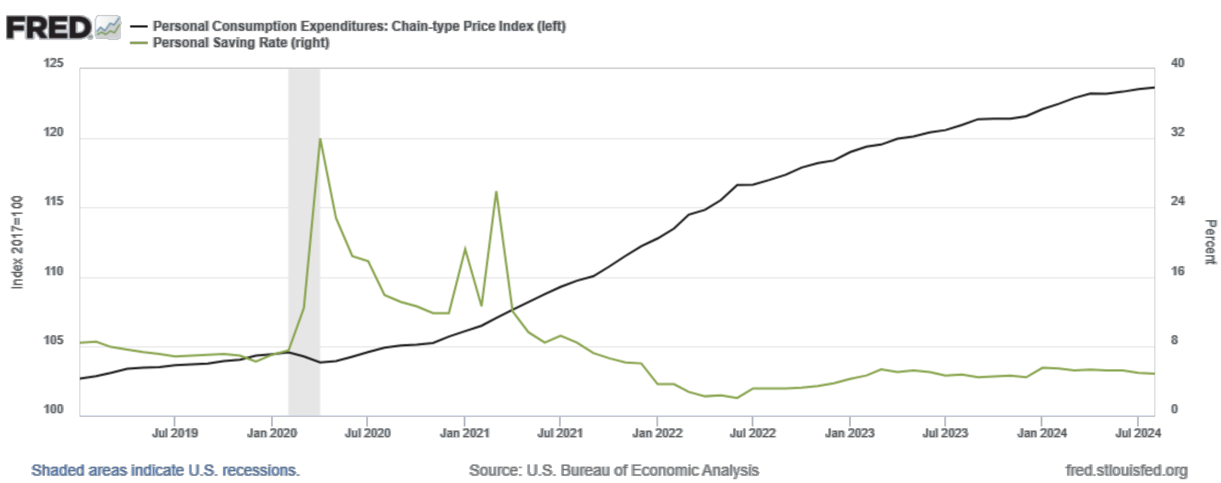
But the banking industry sometimes gets short shrift when examining the overall health of the economy (until there is a crisis).

So, let's take a look.

A significant percentage of economic growth in the US is driven by consumption (60-70%). Low interest rates and massive fiscal stimulus programs over the past few years certainly drove increased consumer spending.

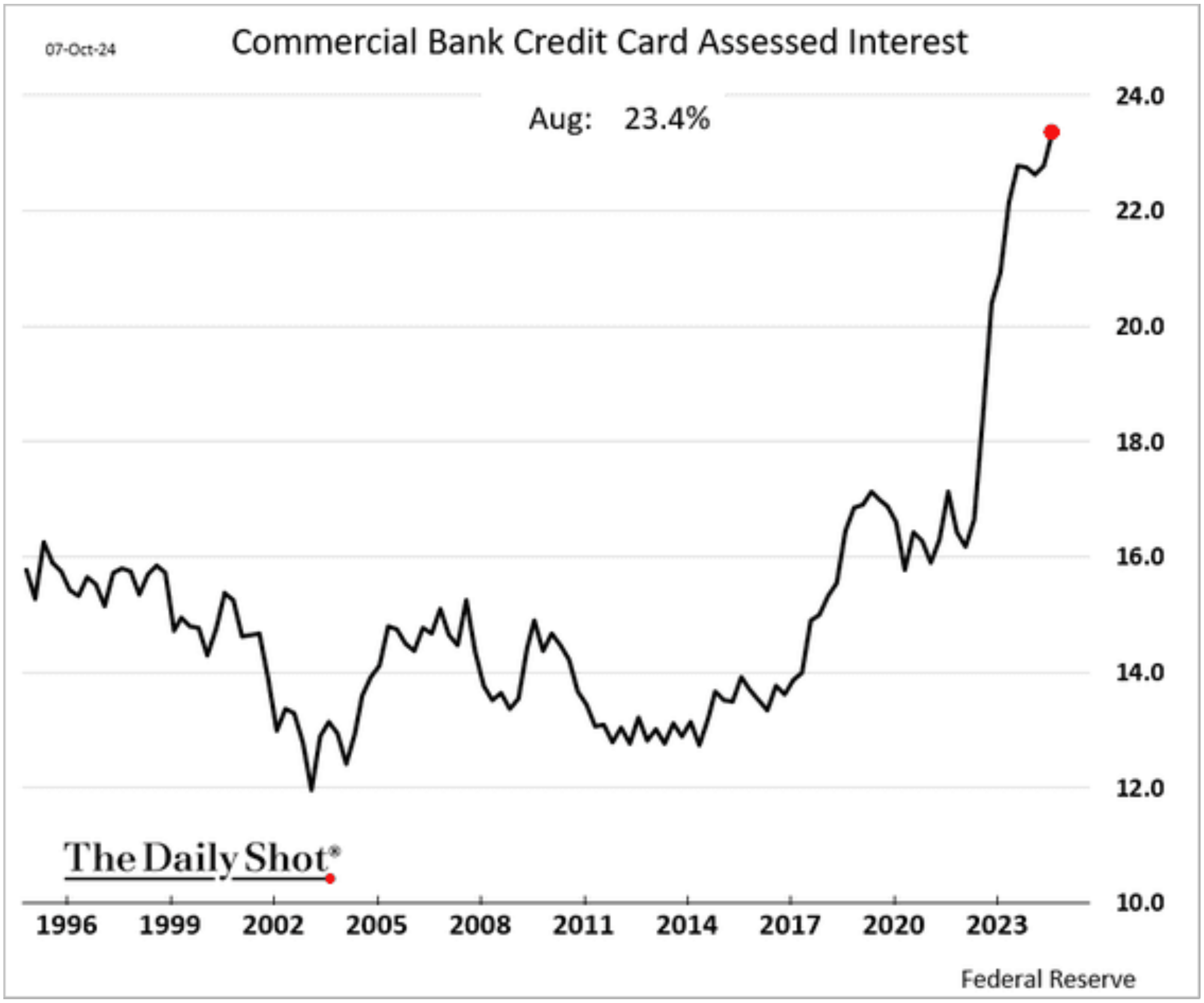
But since the Fed began raising rates in March 2022 (until cutting them again in September, with suggestions for more cuts to come) some interesting developments have occurred.

While personal consumption continues to rise, the personal savings rate continues to fall (though it may be stabilizing) – consumers have blown through their stimulus money.



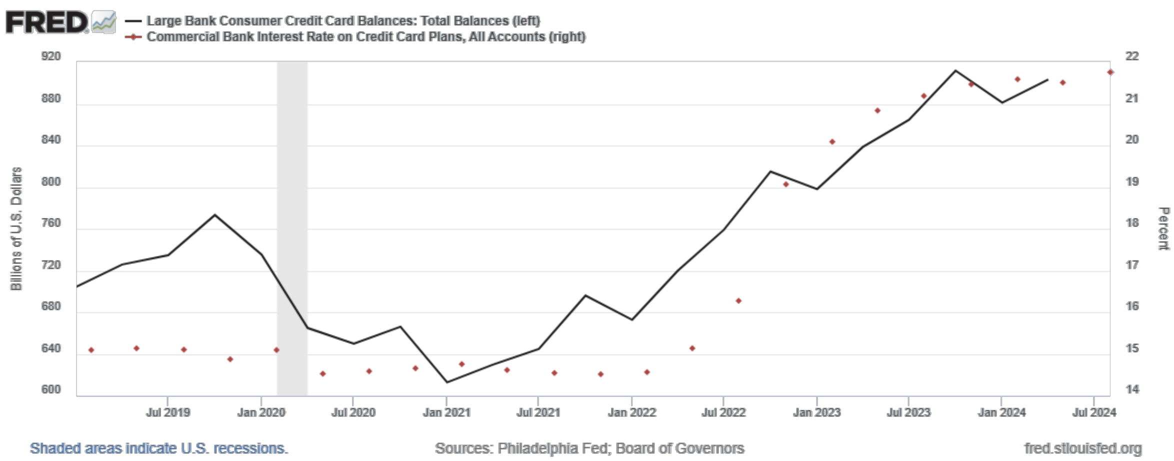
Source: St. Louis Fed (FRED), through August 2024.

Since consumers have spent down their savings but not slowed their consumption, they are rediscovering their credit cards. Nothing wrong with that, *per se*, except that credit card interest rates are skyrocketing, and the average rate is now approaching 24%.



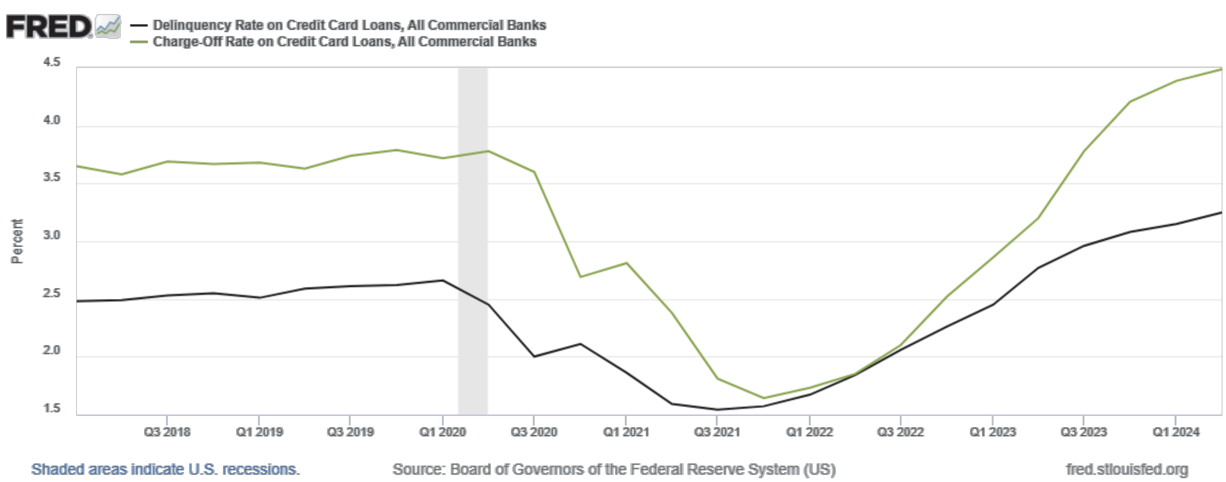
Source: The Federal Reserve and The Daily Shot, through August 2024.

This may have a significant impact on consumer spending going forward, with a corresponding impact on economic growth.



Source: St. Louis Fed (FRED). Credit card balances (black line, left scale) are through Q2, 2024. Credit card interest rates (red dots, right scale) are through August 2024.

As might be expected, the combination of rising usage and higher rates has resulted in a corresponding increase in delinquency and default rates.

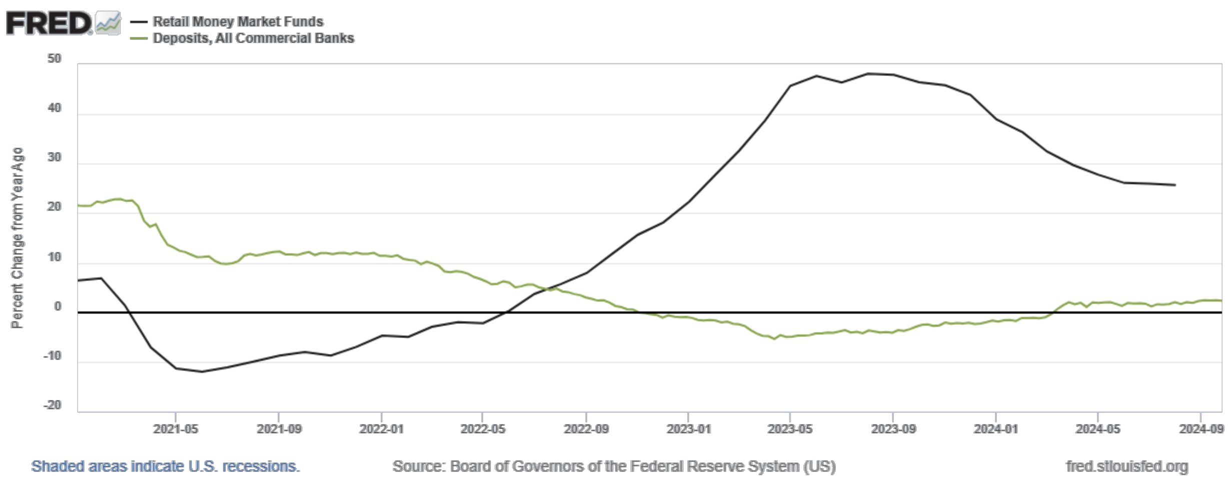


Source: St. Louis Fed (FRED), through Q2 2024.

Personal consumption is not the only factor driving down the savings rate. As the Fed began its rate hike regime, money market funds responded by raising their offered interest rates as well. Banks, however, did not follow suit, and the differential between offered deposit rates versus money market yield approached 5% or more.

When combined with the regional bank scares / failures of 2023 with Silicon Valley Bank, Signature Bank of New York, and First Republic Bank, banks saw massive outflows of deposits that were then invested into money market funds. That trend appears to be abating as banks slowly increase their offered savings rates.

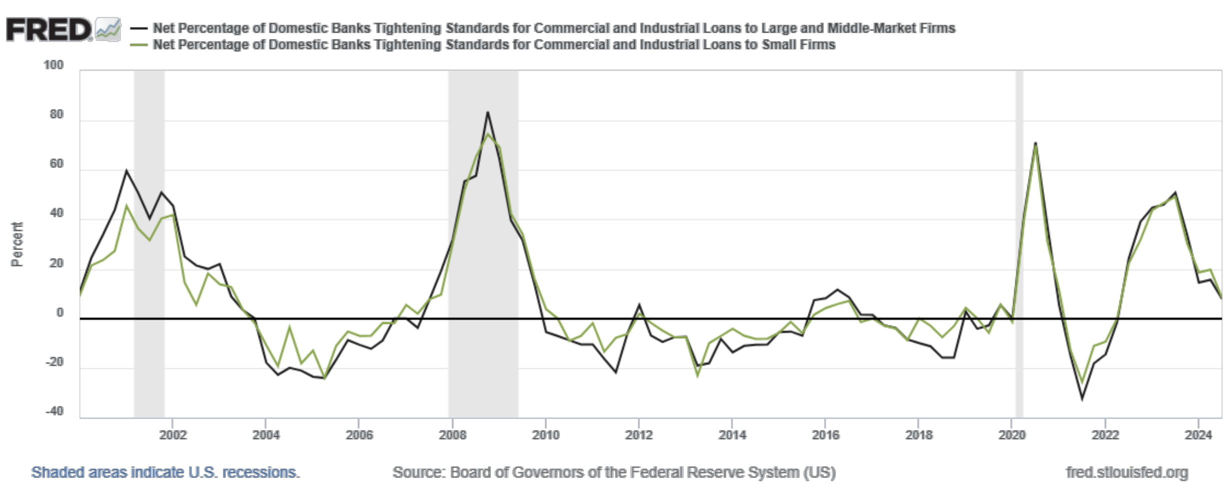
Investor inertia (i.e., reluctance to move money out of federally insured bank deposits and into money market funds) is a real thing and probably prevented this reallocation from being larger.



Source: St. Louis Fed (FRED) Money market data through August 2024. Bank deposit data through September 2024.

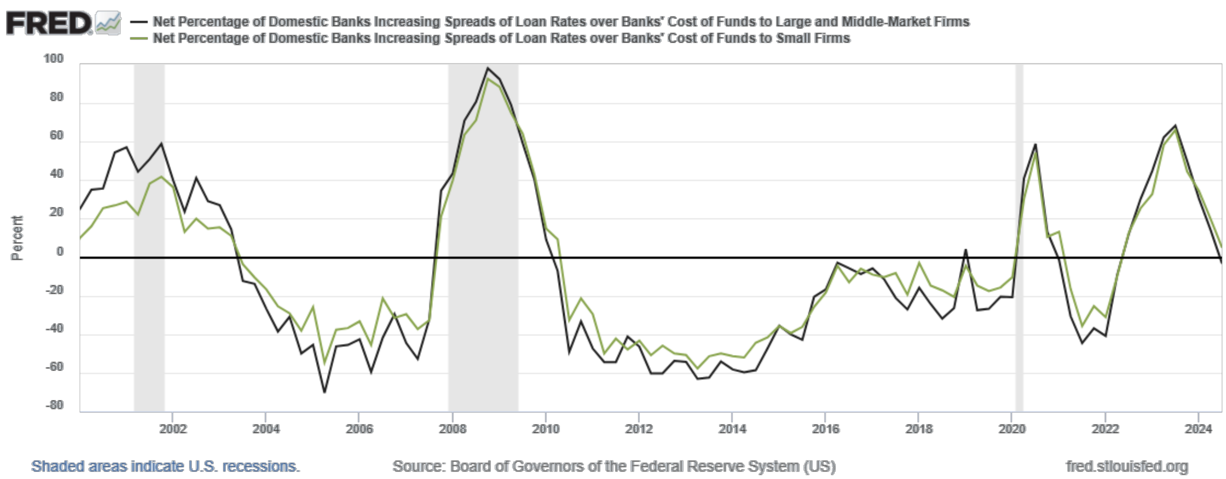
Shifting focus, the turmoil in the smaller and regional banking sector during 2023 referenced above was widely publicized. Failures at these regional banks highlighted the dangers of asset and liability mismanagement, overexposure to commercial real estate, and the difference between "available for sale" and "hold to maturity" capital base investments.

One consequence is that banks tightened their lending standards (made it more difficult to obtain loans). This has eased off a bit over the past several months but the percentage of banks that claim they are tightening standards remains at levels not seen (ex-Covid) since the Great Financial Crisis.



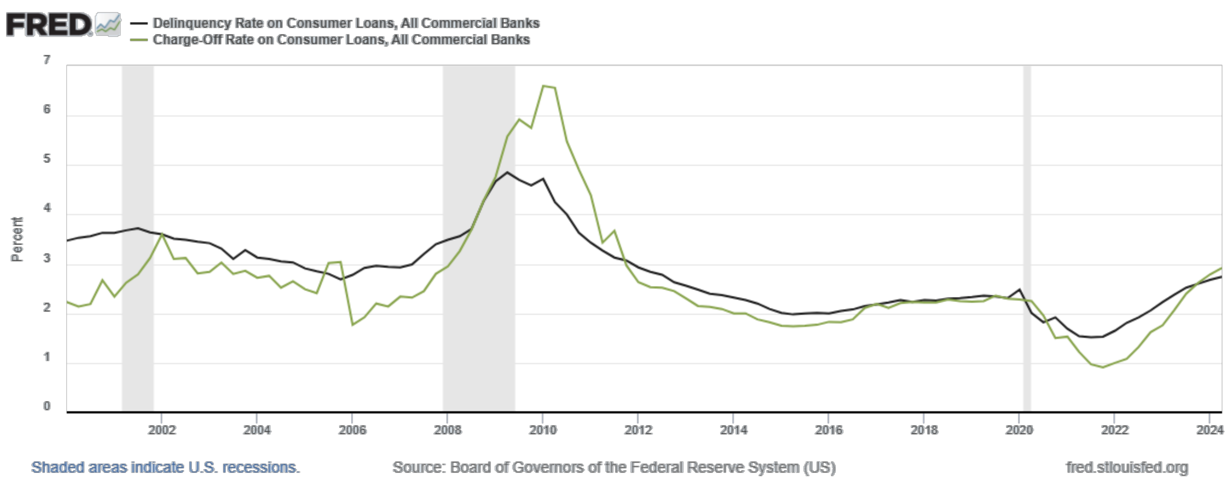
Source: St. Louis Fed (FRED), through Q3 2024.

At the same time, banks are also increasing the credit spreads they charge on consumer loans. The percentage of banks doing so has also declined in recent months, but again remains higher than at any time (ex-Covid) since the Great Financial Crisis.



Source: St. Louis Fed (FRED), as of Q3 2024.

Not unexpectedly, consumer loan delinquency and default rates are rising.



Source: St. Louis Fed (FRED), through Q2 2024.

As the Fed initiated its rate hike regime, mortgage rates also jumped – which partially explains why people weren't moving or buying new homes.

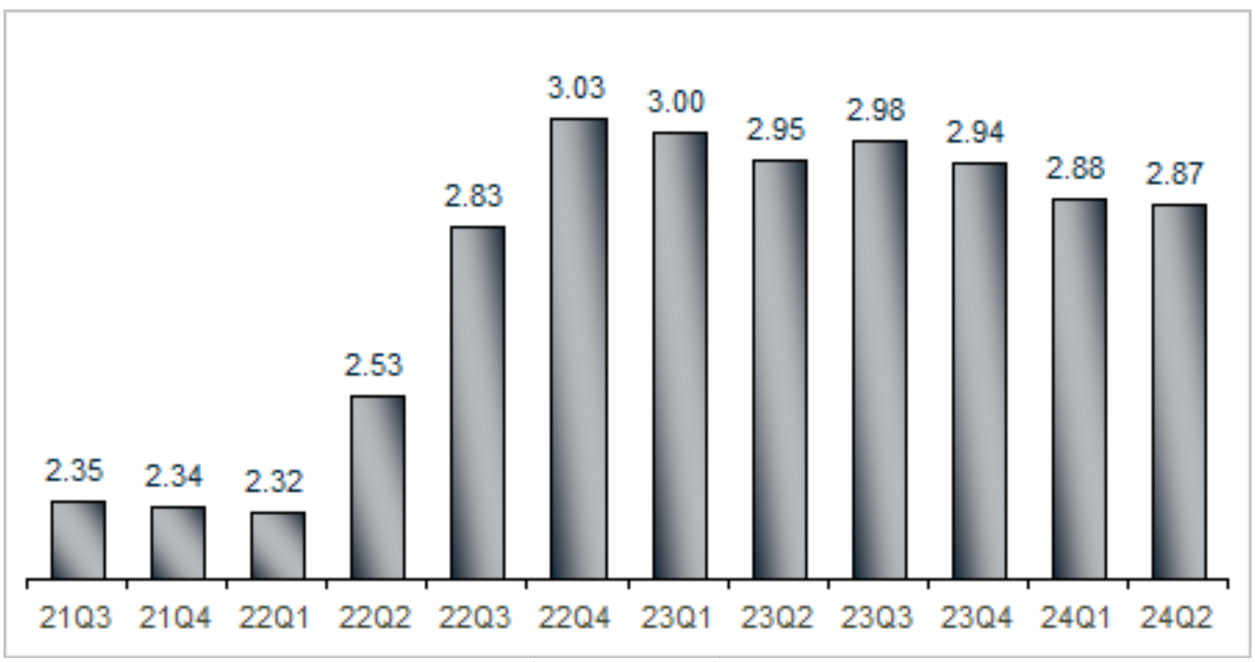
Although mortgage rates have trended downward over the past few months, if you took out a 3% mortgage on your house four-five years ago and are now looking at a 6+% mortgage on a more expensive house, you probably wouldn't move either.

Source: St. Louis Fed (FRED), through September 2024.

One reason banks are slow to increase deposit rates is because so much of their overall revenue comes from "net interest margin" (NIM) – the difference between their borrowing rates (i.e., deposits) and their lending rates (loans, mortgages, etc.).

As interest rates rose while deposit rates stayed essentially flat, we saw banks' NIMs rise as well. This situation presents a dilemma for banks – shareholders want to see NIM maximized while savers want higher deposit rates.

As rates have stabilized but deposit rates have risen, you can see the slow decline in NIM over the past few quarters.

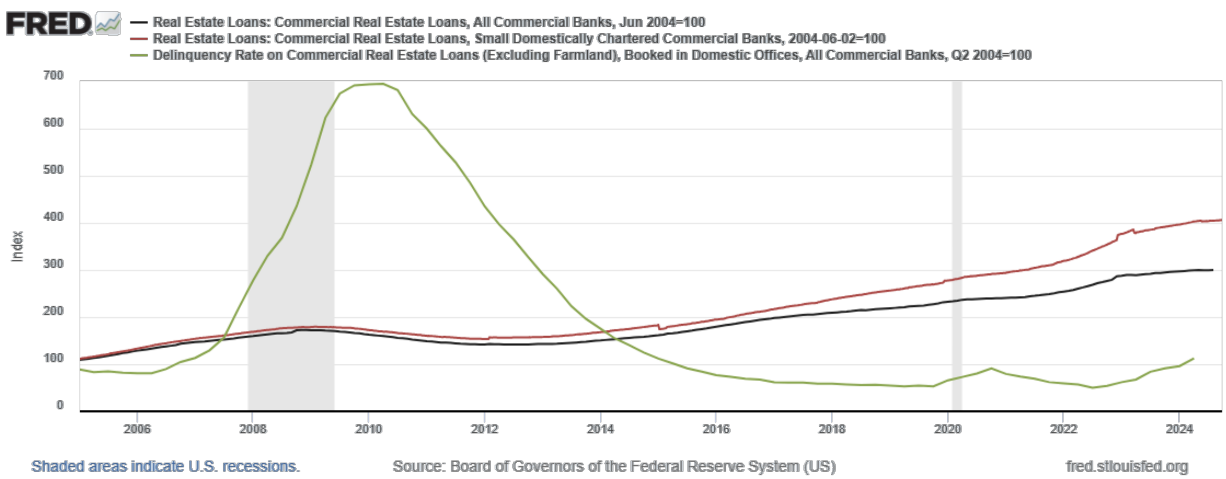


Source: Average Net Interest Margin Percentage for All US Banks from BankRegData.com, through Q2 2024.

Summary and Interpretation

The charts and data summarized in this blog suggest the overall health of the banking industry is reasonably solid. One continuing point of concern is their exposure to the commercial real estate sector, especially among smaller regional and community banks, as that sector is only slowly recovering from its post-Covid slump.

Delinquency rates are rising and many of these loans are facing maturity walls that will force them to refinance in a higher rate environment or enter “extend and pretend” negotiations with lenders.



Source: St. Louis Fed (FRED), data through August 2024.

It is important to remember that smaller banks are more likely to hold these loans on their books versus syndicating them out to other investors via collateralized loan obligations and other similar vehicles, as larger banks frequently do.

There is a risk we may see a wave of delinquencies, defaults, and bankruptcies from the underlying developers and properties as these loans come due or need to be refinanced over the next 2-3 years.

We think a shorter-term economic risk lies in the action taking place in “the numbers behind the numbers.” Depleted savings, rising credit card usage coupled with rising credit card rates, rising delinquency and default rates on credit cards and loans, tightening lending standards and rising loan spreads – all these phenomena have the potential to put a dent in personal consumption, the lifeblood of overall economic activity in the US.

If there is a silver lining to all of this, it is that it has helped support a boom in private credit lending, as unrated borrowers find a more favorable borrowing environment among private lender sponsors than they do from banks.

At Certuity, we are continually active in this space and continue to seek new opportunities.

We have not yet seen any visible impact on the economy from the issues raised in this blog.

But we believe this is an area worth paying attention to as we move through the remainder of 2024 and head into 2025.

Scott Welch, CIMA®
Chief Investment Officer
Certuity

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