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Rate Relief Anyway?

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- * **Fed Cautiously Approaches Policy Rate Hike**
 - Short Rates Conceivably Advance Without Long Rate Accompaniment

- * **Best Case for Banks Is a “Parallel Shift” Up**
 - A Rising Tide That Would Lift Almost All Boats

- * **Second Best Is Only That Short Rates Rise**
 - A Consequential Boost to “Business” Banks Nevertheless

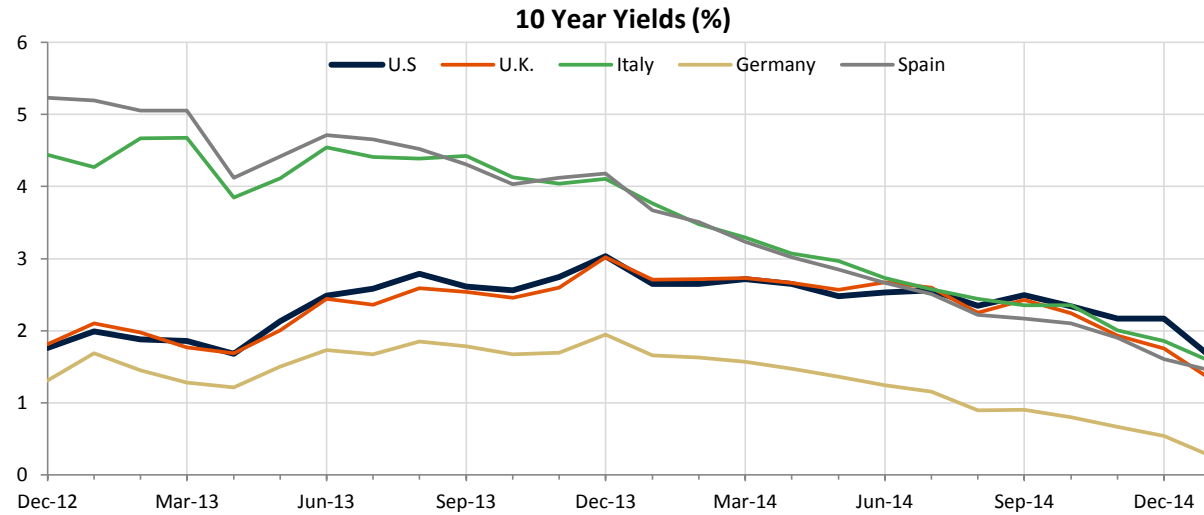
Synopsis: The most likely scenario for interest rates in 2015 and possibly 2016 has been spreading new despair when it should be raising high hopes, at least selectively in financials. The Fed is poised to raise short term rates - not as rapidly as in past recoveries, but who thinks this is like any past cycle? Being data dependent, of course, faltering job growth can defer this action. If employment weakness persists the Fed will presumably wait longer. Long rates look anchored where they are, however. Therefore the yield curve could very well become flatter.

But lenders have far more loans than securities, and if enough of those loans are more sensitive to short rates then consolidated net interest margins will expand anyway. Not as much as if both ends move in parallel, but expansion nonetheless. Loan growth would finally translate into levered bottom line growth instead of the lackluster, low-gear momentum of the past several years.

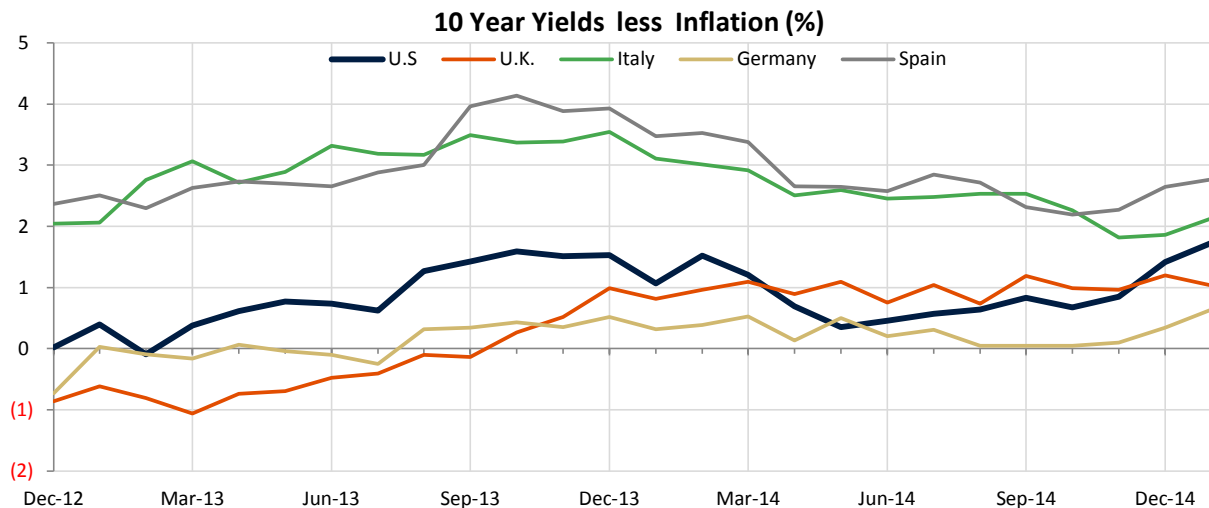
Rather than throwing up their hands on bank stocks, investors should closely review and search for banks whose balance sheet profiles promise upside earnings surprise when short rates do advance, even if long rates fail to follow. Business banking is the prominent beneficiary in this rate scenario, and this same group has been leading loan growth in banking for several years.

An Offshore “Operation Twist”: Speculation remains equally flummoxed at both ends of the interest rate spectrum for now. At the short end, a prospective hike by the Federal Reserve in the “Policy” (Fed Funds) Rate is largely presumed, with only the timing and further increases in debate. But at the long end, central banks are globally contaminating each other’s flexibility and impact, with ECB easing and economic weakness dramatically driving nominal interest rates into negative territory.

Over half of all sovereign Eurobonds now have negative yields, effectively capping U.S. Treasury bond rates. Spain and Italy are particularly perplexing examples of countries with little economic momentum that can borrow below the equivalent U.S. rate without the comparable, low risk! So yield curve pressure mostly rests in the hands of foreign monetary policy and tactics, while the Fed clearly continues to dominate the course of short term rates.



Monetary “ease” has gone global in unprecedented fashion. Examples of 10-year government bonds from Europe and the U.S. are pictured above. The European Central Bank (ECB) has recently capitulated to a period of massive quantitative easing just as the Fed closes the comparable exercise in the U.S. Surprisingly, after subtracting local inflation rates, real interest rates have generally not been a source of new monetary accommodation. Shown below is a very different picture.



U.S. long rates in real terms have actually been rising since last spring! Euro long rates have been rising since early winter. While we would stop short of suggesting this reflects inadvertent monetary tightening, it clearly illustrates that nominal rates are simply unable to catch up with declining inflation in a world of largely stagnant growth. Unless or until European quantitative easing (QE) provokes inflation or more fundamental economic growth, there is little chance nominal long rates rise.

Impact on Financials: Understandably, investors are deeply dissecting factors and fundamentals that impact interest rates. Their analysis of the actual impact on financial stocks may not yet be as deep.

The implications for US financial institutions are complex and can be counterintuitive. Bank stocks in particular have continued to underperform largely due to uncertainty over when or even whether the Policy Rate is poised to rise. Rising short rates against compressed long rates clearly hurts securities portfolios that tend to be funded short. However, US banks average twice more loans than securities and loans have substantially higher spreads. As longer term funding supports this much larger and much more profitable earning asset, any rise in short term rates should markedly offset any squeeze from the yield curve, provided sufficient rate sensitivity in loan portfolios.

Therefore, a rise in the Policy Rate should translate into consolidated net interest margin improvement for the first time since accommodative monetary policy began over seven years ago. There are many other variables, including loan rate floors and capital impact among many others, but the current quagmire can still be significantly supportive to earnings for a large subset of banks. The common prerequisites are business loan concentration, strong core deposit funding and loan pricing discipline. Business banks are clearly favored with their loan rate sensitivity and their outsized demand deposit funding. Conversely, banks that rely more on real estate lending are innately less rate sensitive and may have worsened their position by offering fixed rate loans with extended maturities during the sluggish and narrow credit demand cycle. Discussing this with managements can readily reveal those best positioned for “rate-relief” limited to short term rates.

The most common assumption in interest rate risk modeling, a “parallel shift” scenario in which long rates move up with short rates, would be a further positive to earnings but somewhat negative to capital ratios from Available for Sale (AFS) securities markdowns. Higher interest rates should also be a valuation negative for equities in general, with some of that already reflected in the market. We had assumed long rates would move before short rates, with declining foreign demand for U.S. Treasuries and the cessation of the Fed’s quantitative easing. The reverse has happened from a variety of events over the last several years, including several flights out of the euro, events in the Ukraine and now European QE.

Impact from a parallel shift rate rise is quantitatively available for a large number of banks. This data for 205 banks between \$1 billion and \$100 billion in assets presents a wide range of impact on net interest income. In general, the average and median benefits are a somewhat moderate 2.7% and 1.9% respectively. The 41 banks in the top quintile show average and median benefits of 11.2% and 9.5% respectively. Top decile gains are 15% and 13% respectively.

These are powerful earnings positives that should not be ignored. Translated into net income, the 41 top quintile banks would see an additional 20% to 25% in bottom line earnings assuming a 200 basis point parallel shift upward in rates. Those in the top decile would see a net income benefit in the vicinity of 30%-plus.

Quantitative impact from a rate rise limited only to short rates is less calculable. However, banks with strong demand deposit account (DDA) funding, a preponderance of loans tied to prime or LIBOR and a moderate level of loans with floors can produce a double-digit hike to earnings by 2016 in our estimates, despite any intermediate term yield curve flattening. It is well worth positioning investment portfolios in banks now that fit the balance sheet dynamics favoring a rise limited to short term rates.

We note three significant variables common to top quintile banks with the highest positive rate sensitivity: **1) Heavy C&I** - Commercial and industrial loans average 27% of total loans in the top quintile, versus an 18% average for all banks and 11% for the bottom quintile; **2) Heavy DDAs** - Noninterest bearing deposits (DDAs) fund 22% of total loans in the top quintile, versus an 18% average for all banks; and **3) Moderate CRE** - Commercial real estate tends to harbor more fixed rate product that has experienced increasingly competitive pricing. CRE is also a pervasive category for community and regional banks. As it can seriously dampen overall rate sensitivity, we look at the differential to C&I loans, which are the most sensitive. The top quintile averages only 11% more in CRE than C&I, versus 21% more for all banks and 31% more for the bottom quintile.

Key Balance Sheet Variables

| | Rate Rise as % NII | C&I Loans ----- as % Total Loans | CRE less C&I ----- as % Total Loans | DDAs ----- as % Total Loans |
|------------|-----------------------|--|---|-----------------------------------|
| Quintile 1 | 11.2 | 26.9 | 11.5 | 21.7 |
| Quintile 2 | 4.6 | 19.7 | 14.5 | 17.8 |
| Quintile 3 | 2.0 | 15.3 | 21.4 | 18.7 |
| Quintile 4 | 0.2 | 17.8 | 22.4 | 16.9 |
| Quintile 5 | (4.6) | 10.8 | 30.6 | 13.7 |

For 200bp parallel shift with SOP assumptions
 For 206 banks between \$1B and \$100B in assets
 Data Source: SNL

Rate sensitivity for stocks, particularly financials, is buried in confusion and flawed historical arguments. Fundamentals are often at odds with stock price performance in general. The above analysis suggests rising rates, even if only at the short end of the spectrum initially, are generally a positive for bank stocks. In the near future this should at least be true for banks heavy with business and true commercial clients. Historically, it can be shown that there is little to fear from rising rates and/or flattening yield curves. In fact, the opposite has occurred. The following exhibits bridge fundamental analysis with reality and help debunk this mistaken fear.

First, it is relatively simple to see that bank stocks are not particularly rate sensitive per se. All equities axiomatically have some inverse correlation to interest rates. But when R-squareds are run historically against a variety of sectors for the last 15 years, banks fall toward the bottom.

Correlation to 10-Yr UST Rate

| | |
|------------------------|-------------|
| Consumer Staples | 0.77 |
| Energy | 0.68 |
| Health Care | 0.64 |
| Materials | 0.63 |
| Consumer Discretionary | 0.62 |
| Industrials | 0.61 |
| Utilities | 0.44 |
| Nasdaq/Bank | 0.39 |
| Information Technology | 0.32 |

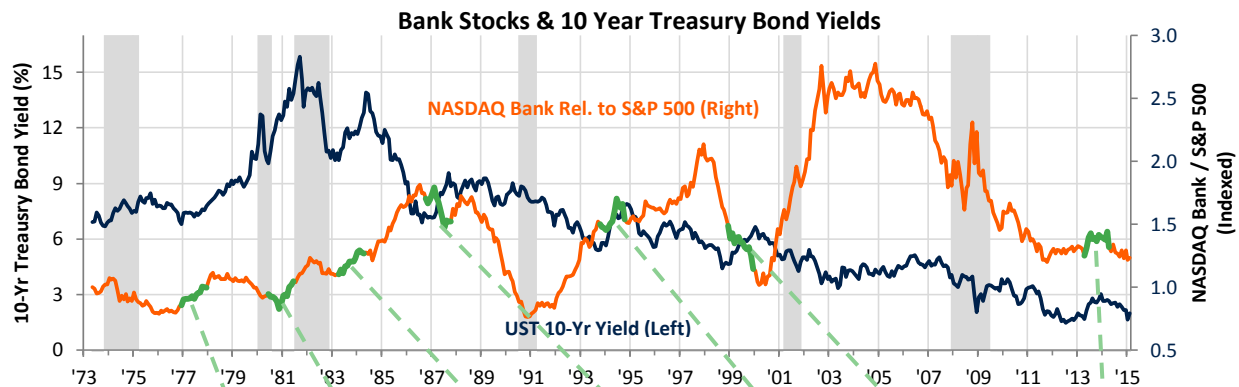
Correlation to Fed Funds Rate

| | |
|------------------------|-------------|
| Consumer Staples | 0.44 |
| Energy | 0.39 |
| Materials | 0.34 |
| Consumer Discretionary | 0.33 |
| Health Care | 0.32 |
| Industrials | 0.26 |
| Nasdaq/Bank | 0.13 |
| Utilities | 0.11 |
| Information Technology | 0.08 |

Data Source: FactSet
 Note: From 1990-to-date

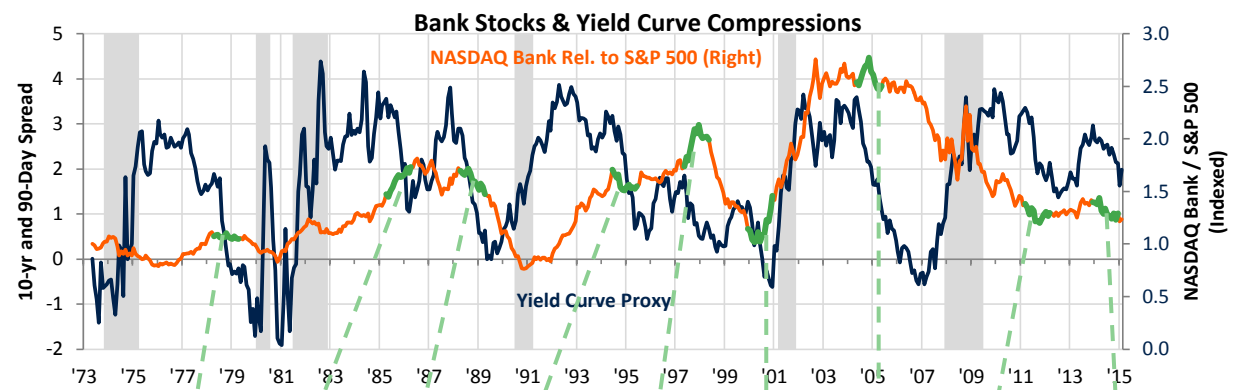
The more granular exhibits below examine four decades of data with multiple periods of rising rates and yield curve flattening. Bank stock performance is shown relative to the S&P 500. We highlighted seven periods of rising rates and nine periods of declining spread between long and short rates. We chose only periods that persisted for at least a year and we tracked relative bank stock performance for the first 12 months in each case.

During rising rates, banks rose in five of the seven periods, and also outperformed the S&P 500. The exhibit shown is against the 10-year Treasury rate, but the same results held against the Fed Funds rate.



1-Yr Performance Following Start of Rate Upturn

| | Dec-76 | Jun-80 | April-83 | Oct-86 | Oct-93 | Dec-98 | Apr-13 |
|-------------|---------|--------|----------|---------|--------|---------|--------|
| NASDAQ Bank | 2.8% | 27.5% | 11.9% | (8.6%) | 3.4% | (8.0%) | 24.3% |
| S&P 500 | (11.5%) | 14.9% | (2.7%) | 3.2% | 1.0% | 19.5% | 17.9% |
| Difference | 14.3% | 12.6% | 14.6% | (11.2%) | 2.4% | (27.5%) | 6.3% |



1-Yr Performance Following Start of Yield Curve Compression

| | Apr-78 | Apr-85 | Apr-88 | Jun-94 | May-97 | Dec-99 | May-04 | Mar-11 | Dec-13 |
|-------------|--------|--------|---------|---------|--------|---------|--------|--------|---------|
| NASDAQ Bank | 2.4% | 53.9% | 2.7% | 11.6% | 47.2% | 14.7% | 4.7% | (0.3%) | 1.4% |
| S&P 500 | 5.1% | 31.0% | 18.5% | 22.6% | 28.6% | (10.1%) | 6.3% | 6.2% | 13.2% |
| Difference | (2.7%) | 22.9% | (15.8%) | (11.0%) | 18.6% | 24.8% | (1.7%) | (6.6%) | (11.8%) |

Data Sources: FactSet, SNL Financial

During yield curve compressions bank stocks posted gains in eight of the nine cases and outperformed the S&P 500 in three.

It is fair to contend that many other variables are at work over such a long economic history, but the results are compelling nevertheless. Unless the Fed retreats it is probably (and finally) time to start looking for the ponies in the barn.

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