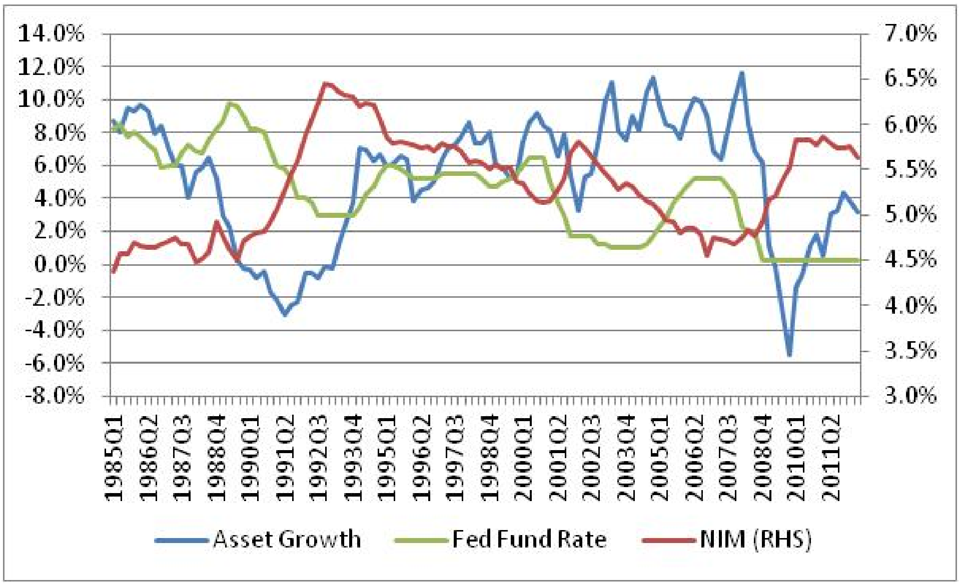
# THE PROBLEM WITH US BANKS

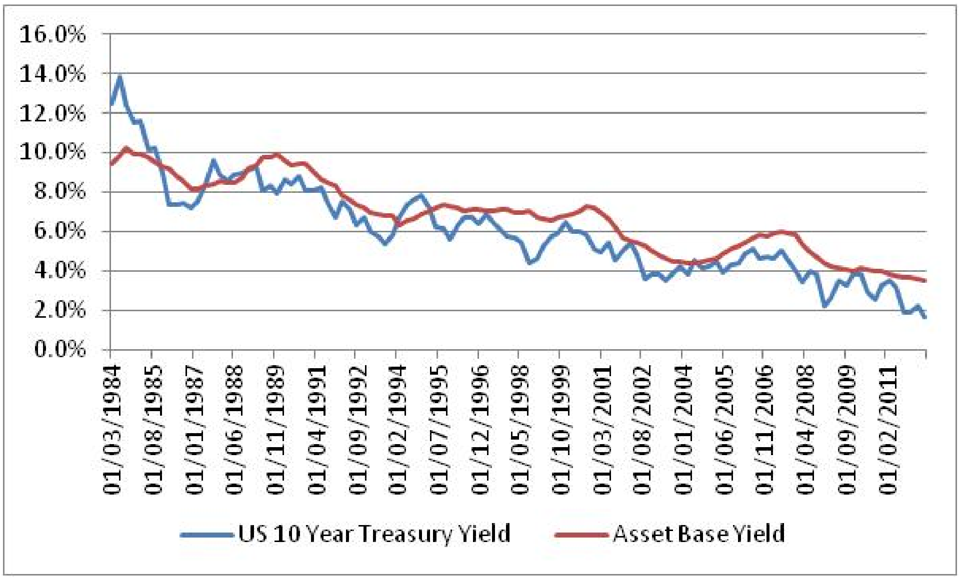

Recent data from the US has been encouraging, with levels of home sales increasing and share prices of homebuilders performing very well recently. Typically such moves would lead investors to expect domestically focused banks to do well, as an improving housing market leads to reduced loan losses and increased loan growth. Unfortunately, data from the FDIC paints a different story.

Banks make most of their money through charging a spread. To put it simply, they take in deposits at a low rate, and then lend it out at a higher rate. The spread they earn between deposits cover their operating costs and should also be used to generate capital to cover any future losses on loans.



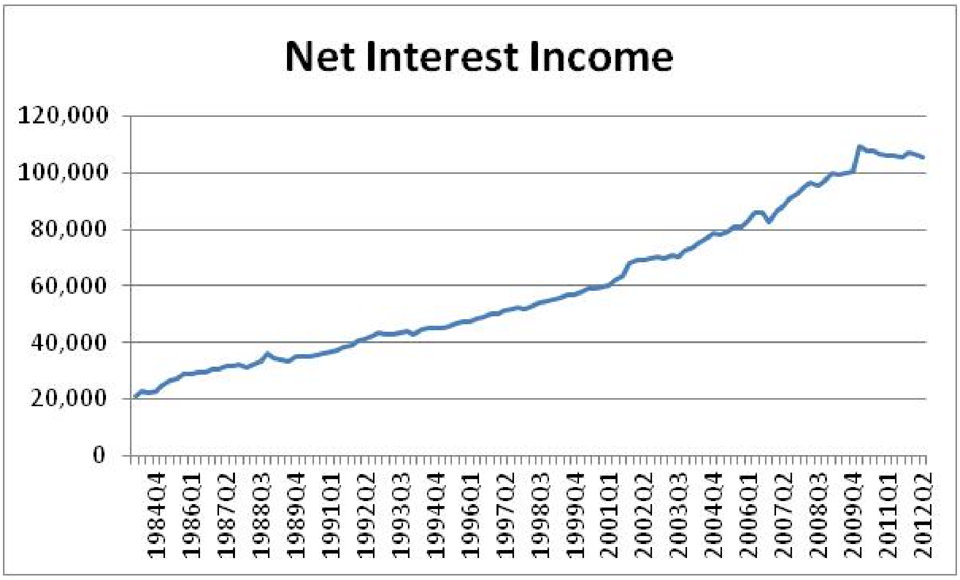

Typically, in a recession, asset growth goes negative for banks, but net interest margins rise as the Federal Reserve slashes rates, and banks are very quick to pass on lower interest rates to deposit holders, but are tardy to cut lending rates. As loan growth returns, net interest margins are reduced as the Federal Reserve normalizes rates.

As we can see from above the graph, the recent recession saw a brutal contraction in asset growth with only tepid growth since then. Due to the low growth, the Fed Fund rate has stayed at zero, but intriguingly we are beginning to see a gradual contraction in the net interest margin (see the red line in the graph above).

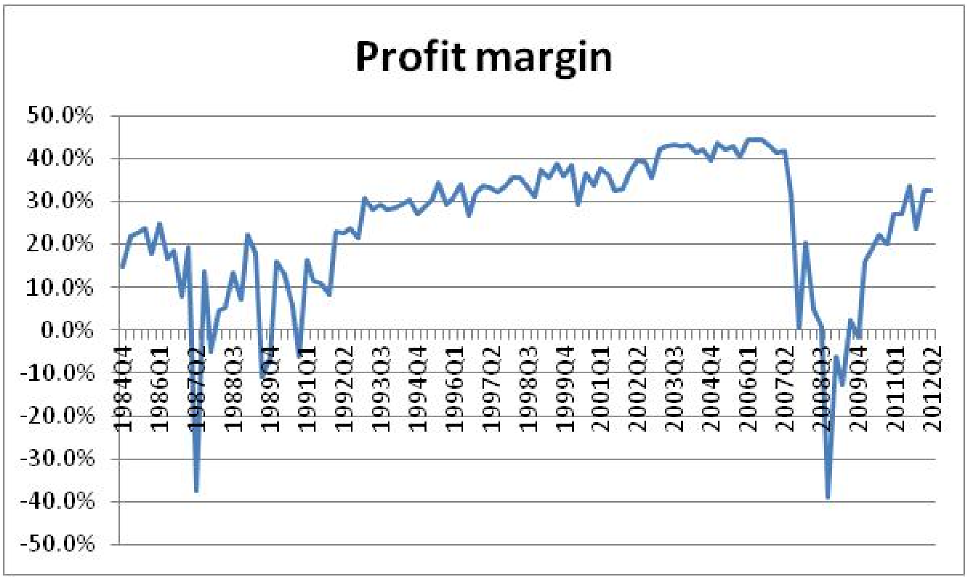



One way to see the problems of the US banking system more clearly is to take the net interest income of the banking sector and divide it by total assets to calculate the asset base yield for banks. As we can see here it has been steadily declining for years and generally follows the yield on the US 10 year treasury. Given the recent move lower in 10 year bond yields, we should expect the asset base yield on US banks to move lower.

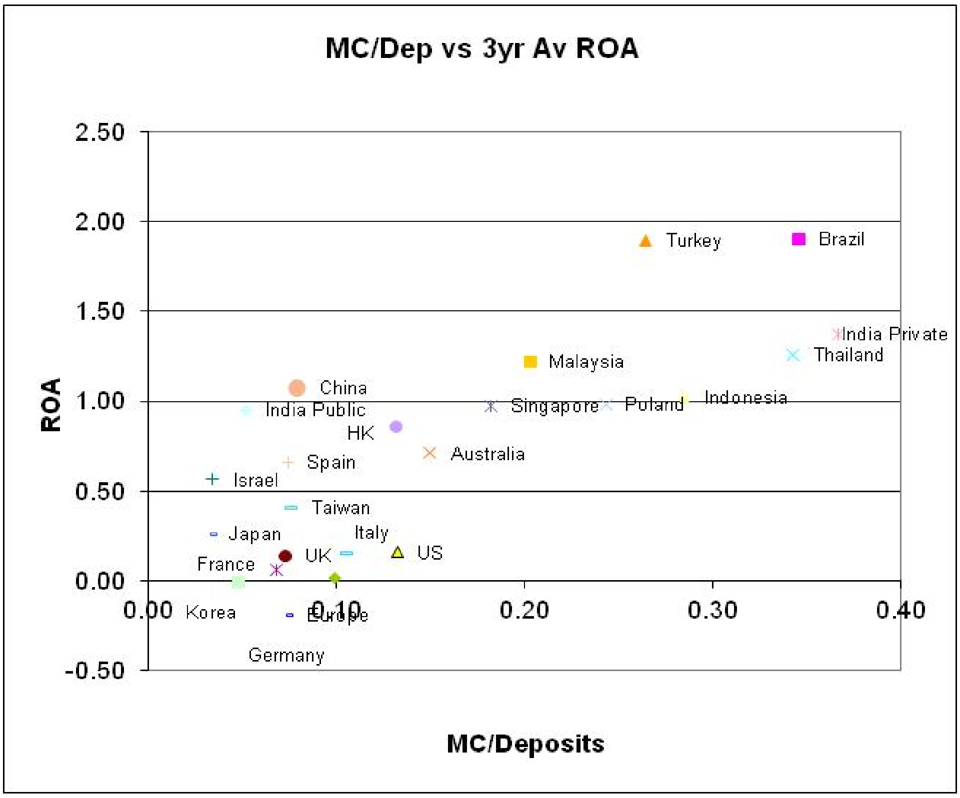
In concrete terms, lower yields and low loan growth mean that interest income accruing to US bank industry is not growing.




As can be seen above, total net interest income to US banks is beginning to decline. Unless we see a change in the interest rate environment or an increase in loan demand, stagnant net interest income would be the best possible outcome for US banks, with the chance we might see net interest income decline.




Banks in the US could continue to post profit growth if margins continue to increase. On an aggregate basis I like to look at net margin as a percentage of net interest income. While it does potentially oversimplify banks earnings, it does provide a fairly good idea of whether we are closer to a top or bottom in bank profitability. In my view it looks like we are closer to a top than a low.




As can be seen above, bank industries tend to have a market cap to deposit ratio that is closely related to its return on assets. Current ratios for US banks (at around 13%) put it on a par with countries that have faster asset growth and higher interest rates. In other words, the markets seem to be pricing a brighter outlook than what current bond yields imply. To me US banks offer a good risk reward as a short.

## INFORMATION

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