What the Interest-Rate Upheaval of 2019 Means for 2020

DEEP DIVE

Financial analysis for financial services

BY BOB WARNOCK

At this time last year, most U.S. bank management teams were anticipating a flattish path for domestic policy rates. Expense initiatives and improved analytics were the favored investment opportunities to sustain profitability and growth. But the rate environment changed dramatically and unexpectedly, laying waste to the most robust plans.

As we head into 2020, forward policy is even less certain than it was at the end of 2018. What does this mean for the industry?

A LOOK AT 2019

Looking back to the beginning of 2019, the yield curve still offered a fair amount of optimism about forward prospects. Additionally, the market-implied policy rates one-year-out were still anticipating rate levels of roughly 2.6%.

But the declining three-month/five-year curve foreshadowed an increasing level of economic uncertainty, leading the Citi Economic Surprise Index to fall from +7 to -61. As a result, implied volatility in the U.S. interest rate market increased by 59% from December 2018 to June 2019, marking the highest level since 2016.

Despite the increased volatility, bank anchor yields held steady at first. But economic events eventually impacted market-implied policy rates.

At the start of the year, markets were signaling the chance of a single increase by the end of 2019. By June, markets had flipped and were signing that three or four cuts were likely. The three-month Libor spread declined 36 basis points (bp) and the overall Treasury curve inverted significantly.

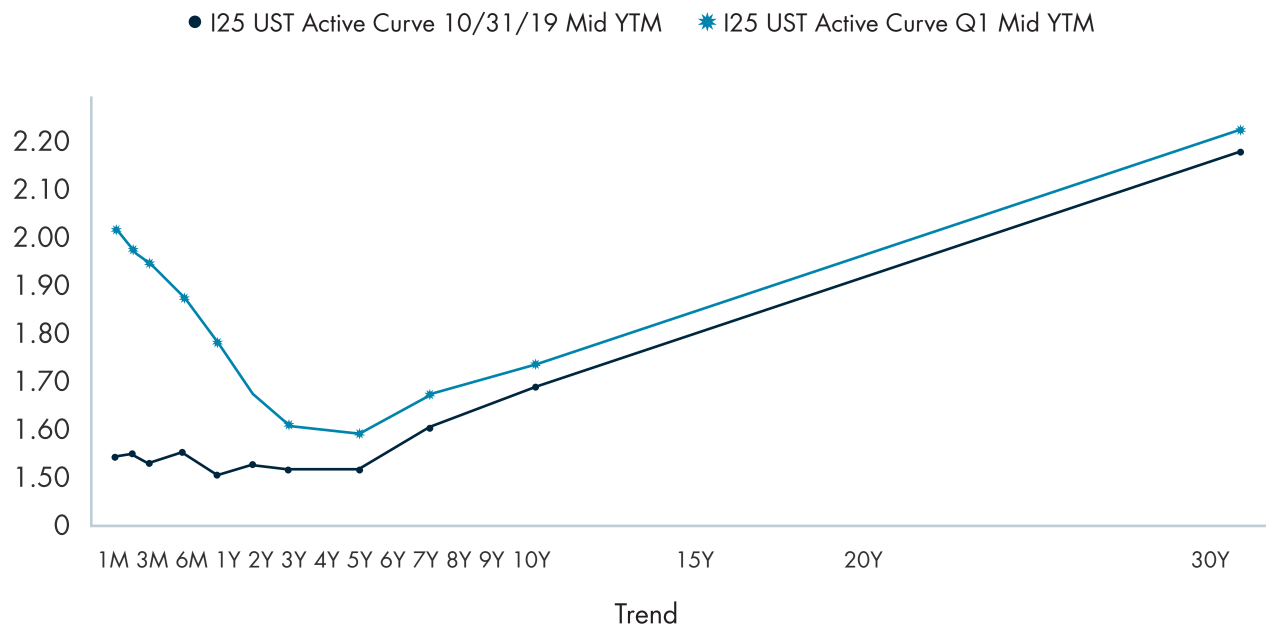
This was particularly painful for banks that rely on commercial lending for revenue growth. Unfortunately, it occurred at a time when banks' back books were also coming under pressure. Together, the two events squeezed net interest margins in the first half of the year.

These events, combined with a kerfuffle in repo funding, yielded three consecutive cuts by the Fed between July and October. Fed Chairman Jerome Powell has suggested that the current range of 1.50-1.75% is appropriate for now. However, both doves and hawks are offering assorted views for 2020.

PLANNING FOR UNCERTAIN TIMES

The direction of rates remains highly uncertain despite Chairman Powell's message in October. The yield curve moved out of inversion between the end of July (when the Fed first cut rates) through October, with the front end falling roughly 60 bp

FIGURE: YIELD CURVE TRENDS | U.S. TREASURY TERM STRUCTURE



Source: Bloomberg

while the tail declined about 20 bp across tenors. The resulting three-month/five-year curve was the steepest seen since the year's first quarter. Furthermore, the curve has been incredibly volatile since then, moving from being relatively flat to threatening to invert again.

Making things more complicated is that economic data has improved since June. The Citi economic surprise index has improved to +7 from an absolute level of -61 in June. While the Fed dominated the front end of the curve, the macro data points helped to elevate the tail end. Finally, the employment picture remains robust with the most recent report beating expectations.

While these economic trends support the current Fed halt, additional economic improvement may force the central bank's hand earlier than expected. Following the Fed cut in October, forward policy rates were expecting at least one additional cut by the end of 2020. But after just eight days of positive economic data, the market changed position to signal no further action over the next 12 months.

While the first half of 2019 behaved adversely relative to expectations, the second half of 2019 also proved very difficult to navigate — especially since the uncertainty occurred just as banks were preparing funding budgets for 2020 and beyond.

ROUGHLY 53%
of U.S. savings deposits are yielding less than 25 bp.

Predicting market rates is a fool's errand, especially this late in the cycle. One thing is for certain: 2020 doesn't present the lay-up that was in place before 2015, when banks were positioned to lean into asset sensitivity.

Bank management teams, from treasurers and lines-of-business heads, will need to be armed with the best possible analytical insights of their portfolios so that they can be nimble with their decisions in 2020. For this to occur, continual investment in analytics, such as marginal cost of funds and customer scoring, will be key to understanding portfolio behaviors and maximizing profitability in 2020.

While this may sound unintuitive in a year of significant profitability risks, it should be noted that neobanks and their fintech peers are investing heavily to take advantage of the volatility to come.

If policy rates remain unchanged over the next 12 months, we can expect to see further pressure on profitability. This will be a very different environment than that of 2010-2015; rates aren't headed to zero, direct banks are capturing retail share and the fragmentation of customer wallets by fintechs continues to evolve. Simply maintaining a neutral balance sheet or leaning liability/asset sensitive will no longer be enough to ensure peer leading profitability. ■

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