July 18, 2023

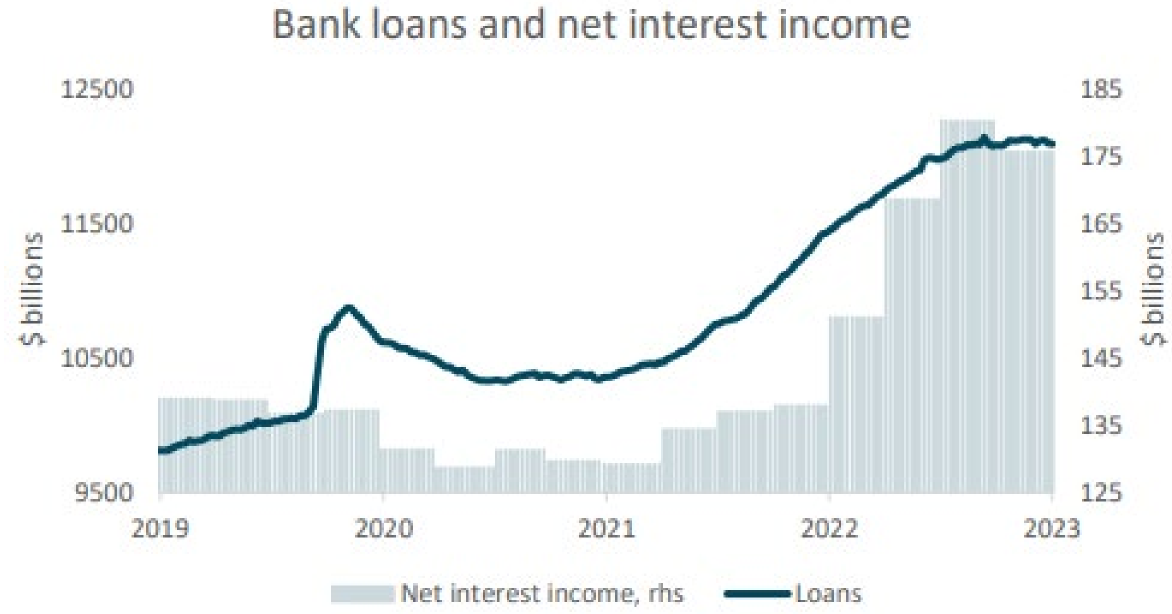
US Banks' Net Interest Income In Focus

Net Interest Income Plateau?

Net interest income will likely be a key focus for US banks during the current earnings season. Several months ago, we were concerned that NII would be under pressure across the banking industry, a function of higher funding costs crimping margins and lower credit growth crimping volumes. The chart below shows the behavior of NII against banks' loan supply. NII is a quarterly figure calculated by the FDIC; Q1 2023 data is the latest available. There is, in just the last five years for which data on the chart is shown, a correlation between loan growth and NII, which makes intuitive sense. Going further back, there has been a stable and positive correlation between the two series since the beginning of the century. We don't have visibility on the individual components of NII, but we do know there is pressure for banks to increase deposits rates (part of their funding costs), at the same time loan growth appears to have peaked and is set to fall in future quarters.

For example, in the New York Fed's most recent Survey of Consumer Expectations, loan applications experienced a 21.8% rejection rate, the highest since before the pandemic (not including March 2020), and loan demand is at its lowest rate since the data began in 2013 (again, not including the quarters during the lockdown). We have been forecasting a slowing in credit provision and demand ever since the banking sector stresses of March and April. We see this slowing the economy gradually and, relatedly, impacting banks' interest income.

Loan Volumes A Risk To NII



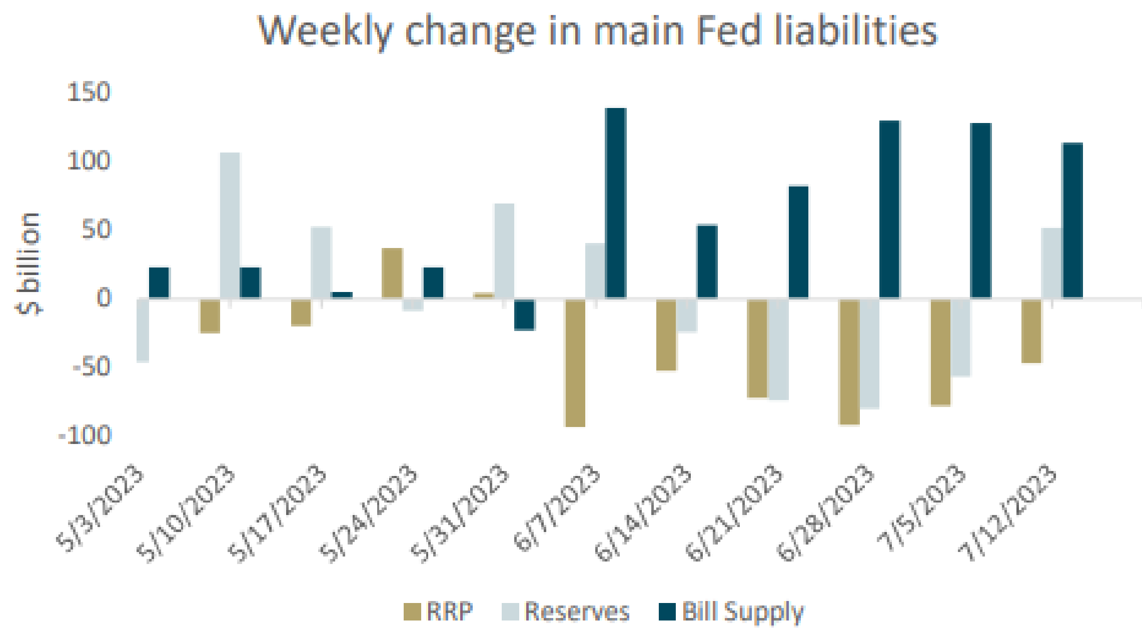
Source: BNY Mellon Markets, Federal Reserve Board of Governors, FDIC

Checking In On Refunding To Date

T-bill supply should slow for the remainder of July given the Treasury's replenishing of its General Account. Through last Wednesday, net supply was almost $650bn since the end of the debt ceiling impasse. The TGA has now increased from just $22bn on June 1 to well over $500bn through last week. As we have noted, this refunding has generally gone without a hitch. The chart below shows weekly changes (in levels) in bill supply, Fed reserves, and reverse repurchase facility usage. Since the beginning of June, RRP take-up has declined by a total of $434bn, representing over two thirds of net T-bill issuance over that same period. Reserves are down $142bn, not quite making up the difference between bill issuance and RRP drainage. Interesting to note in the week ended Wednesday July 12 is that reserves in the system actually grew by a little, +$50bn. With bill supply set to slow, it remains to be seen how much reserves change in the next few weeks, and whether the RRP drawdown will continue at the same pace, both overall and as a percentage of net supply.

The T-bill curve is somewhat cheaper than a month ago. Yields through Sept. 20 (the date of the FOMC meeting after this month's) are an average of 24bp higher than they were after the June 14 FOMC, a function of both the increased issuance and higher expected federal-funds rate. Bill yields might not rise much after the July 26 FOMC meeting, given our view that a hike then will be the last in this cycle. With a 25bp hike in the funds rate expected this month, this translates into a likely 5.3% RRP offering rate, which we think could be difficult to compete with on the bills curve. RRP might not drain as quickly thereafter as it has thus far.

Week-To-Week Changes



Source: BNY Mellon Markets, Federal Reserve Board of Governors, Bloomberg

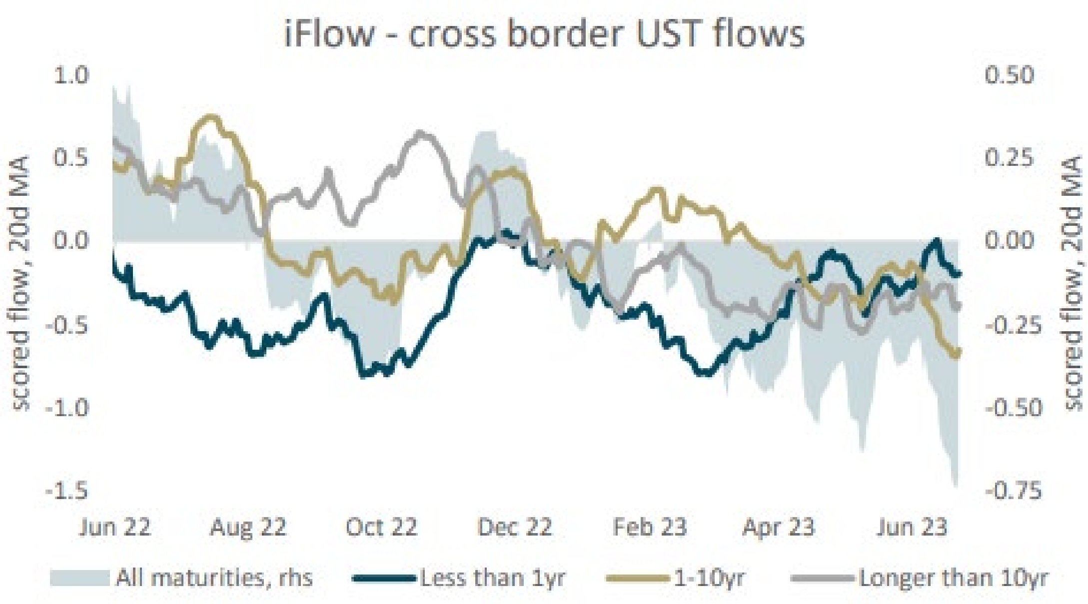
Foreign Demand Still Missing

We have consistently highlighted cross-border selling of US Treasuries by real money investors. This week we check in again on our iFlow data and notice that not only are flows still negative, they have actually deteriorated further in recent weeks. The chart below shows total (scored) flows as well as those for the three maturity buckets we currently track.

The blue shaded area of the graph is total scored flow (20-day rolling sum) of cross-border investors' demand for US government bonds, as well as those securities with less than 1 year in maturity, 1 to 10 years, and 10 years and over. All three categories remain negative and have in fact taken a turn lower in recent weeks.

Watch this space we approach the early-August refunding announcement by the US Treasury. We expect a significant amount of issuance in the remaining months of 2023, and across most of the curve. Foreign demand being so low – indeed negative – could complicate the successful placement of this debt.

Still Falling



Source: BNY Mellon Markets, iFlow

Please direct questions or comments to: iFlow@BNYMellon.com

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