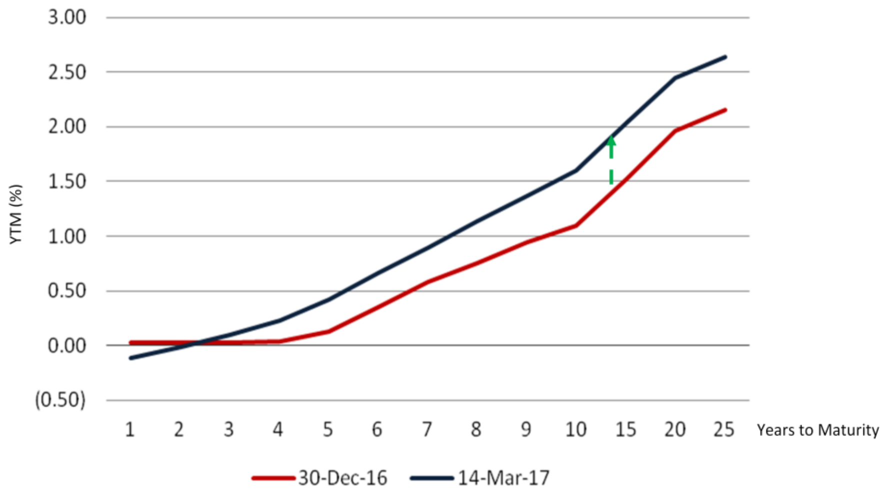
EVERY CLOUD HAS A SILVER LINING

by David Curmi

Or does it? Over recent months we have seen what we believe is the beginning of a change in landscape in the yields on Euro government bonds. This change has manifested itself in steep falls in government bond prices, most especially at the long end. A quick look at the Malta Government bond yield curve below shows the impact that these price movements have had on the yield curve with a shift upward taking place, primarily at the long end.



Source: Malta Stock Exchange, Curmi and Partners Ltd

Whilst this is not necessarily good news for investors who have bought and still hold these bonds, it is most likely a welcome development for the banking sector. In its rawest form, the business of banking entails borrowing over short periods from depositors on the one hand and lending to its clients in the form of commercial loans or mortgages, for long periods on the other. This model had become increasingly challenged for local banks as the European Central Bank progressively cut the interest rate it offers on deposits that banks place with it to the current minus 0.4%. For Maltese banks this was a double whammy. Given the presence of a substantial deposit market in Malta, combined with an economy whose growth did not depend on industries that required much capital, banks found themselves with significant amounts of surplus cash. Cash that in many cases had to deposited with the ECB at a cost of 0.4% per annum. Additionally due to the dynamics of the local deposit market, banks struggled to reduce their deposit rates to 0 or even below. In practise this meant that margins were squeezed. One can see this effect through the net interest line on banks' financial statements. This has largely flatlined for HSBC whilst BOV has only managed minimal growth since the 07/08 crisis.

Naturally this was not the only cause of these shrunken profits. The benign economic environment, significantly greater regulation and greater provisioning against non performing loans also played important parts.

Yet the move upwards in long yields will allow banks greater headroom as they reprice their loans to take into account these movements, whilst their cost of funding remains largely stable. A quick look at the chart again will quickly indicate the extra margin that banks could soon be able to take advantage of. In fact these government bond price moves must feel like the first rains after a long drought, to banks generally. To be fair though the outlook for banks is still challenging as the onslaught of regulation, much of it well needed, has trapped banks in a python like constriction suffocating their ability to provide much needed finance into the economy.

This may also be changing. In the US, big banks have been basking in new found sunlight on expectations that President Trump will begin the process to release some of the shackles that the Dodd Frank reforms imposed upon them. Whilst too little regulation creates its own risks, too much also causes stress in the flow of money to where it may be needed, and a push back of some areas of regulation which have suffocated the release of finance into the economy may be well timed. It remains to be seen if this happens in the US and more so if Europe follows suit, but if nothing else one can look at carefully selected banks and begin to consider them as potentially investable entities once again.

We have not turned the corner yet, and banks will continue to face significant headwinds in their quest to improve profitability, most notably from the regulatory environment, but if the current trend in yields continues then a key foundation stone will be in place to provide a springboard upwards in profitability. Next stop – a more business friendly regulatory regime. Don't hold your breath!