Inflation, interest rates and Wells Fargo

"Inflation targeting" is the bedrock of modern monetary policy. Central bankers specify an inflation target and tweak interest rates accordingly as inflation breaches the target.

It has been hard to ignore the topic of late. Inflation rates in the US have soared to close to 40-year highs of over 7%, driven by a combination of supply chain shortages and pent-up demand. The Federal Reserve's 2% target seems a distant memory and their credibility is now being tested. Having previously insisted that inflation would be "transitory", Fed Chair Jerome Powell acknowledged earlier this month "it's probably a good time to retire that word". In December 2021, the individual interest rate projections published by members of the Federal Reserve (a.k.a. "dot plots") indicated a consensus of three 25 basis point increases in 2022. Now, Fed expectations call for four rate rises or more. Economists at Morgan Stanley and Goldman Sachs are also now predicting four rate rises, whilst Jamie Dimon, Chief Executive of JP Morgan, recently said he sees a possibility of six or seven hikes.

We make no predictions regarding the number of hikes or the size thereof, but what we can say is that it seems all but certain that interest rates will be raised materially over the coming months. And that brings us to Wells Fargo.

Wells Fargo is the fourth largest bank in the United States as measured by total assets. However, Wells is unlike large peers JP Morgan, Bank of America, Goldman Sachs and Morgan Stanley, with a business model and balance sheet more resembling a regional bank. Wells' assets are primarily corporate and retail loans, as opposed to "securities" which are more volatile. The company's liabilities are heavily weighted towards deposits, as opposed to debt. The net result is that Wells Fargo's earnings have more leverage to rising rates than other large peers. As interest rates rise, Wells can increase the rates which it charges customers to borrow money. Whilst Wells' own interest costs which it pays to deposit holders will rise too, the correlation is not exact. For example, some of these deposits will be in non-interest-bearing current accounts and some will be on fixed rates and so would increase but with a lag.

During the initial months of the pandemic, other large banks' earnings were boosted by volatility in their sales and trading businesses. Later on, low rates and dislocations in valuations precipitated a boom in M&A and IPO activity.

On the other hand, Wells' earnings were severely impacted by the collapse in interest rates, with no offset. In addition, there were concerns around whether the pandemic would cause high levels of default rates and therefore large write-downs of loan values. Wells' shares suffered during the height of the pandemic and the unprecedent monetary stimulus which followed. However, things have not turned out so badly, default rates have remained low and savings rates have actually increased. Moreover, with rates poised to rise, Wells now appears better positioned than its large peers.

Since 2017, Wells' earnings growth has been hampered by an asset cap imposed by the Federal Reserve as a result of the unauthorised accounts scandal. As a result of this, Wells has been constrained in its ability to invest the cash which the business generates in making new loans and have been unable to grow. Since appointing a new CEO in 2019, Wells has made significant progress in terms of improving its internal regulatory procedures as required by the Fed for the removal of the asset cap. Substantial personnel changes have taken place at the top of the bank including hiring a new Chief Risk Officer as well as new Risk Officers for each division. The latest quarterly commentary from peers suggests that demand for loans is improving, which positions the company favourably if and when these caps are relaxed. In the meantime, Wells is able to return cash to shareholders through share buybacks and dividends. Furthermore, the bank has a significant opportunity to improve margins and therefore profits with an ongoing cost cutting programme.

Despite the recent rally, Wells still trades at one of the cheapest valuations of any bank despite boasting one of the best outlooks for EPS growth. Given the current outlook and valuation, we thus remain confident in our position. ■

Important notice