



Why Bank of Montreal Is a Buy After the Interest Rate Cut

Description

Recently, the Bank of Canada reduced its key overnight interest rate from 0.75% to a low 0.5% — this would represent the lowest interest rate since 2010. The overnight rate is essential, as it determines the rate in which banks borrow from other banks, and therefore serves as a guideline for all interest rates. When the overnight rate falls, all interest rates typically fall with it.

For banks, this can be bad news. Banks make money on the spread they earn between interest paid to depositors, and interest made from loans — this is known as the net interest margin, and serves as the banks profit. When interest rates fall, banks often see their margins shrink, as interest charged on loans often falls faster than interest paid to depositors. Currently, net interest margins are at the lowest they've been in over a decade.

Fortunately, **Bank of Montreal** ([TSX:BMO](#))([NYSE:BMO](#)) is uniquely suited to not only retain profitability in this tough environment, but possibly even benefit. Here's why.

Bank of Montreal has strong U.S. exposure

There is no question that the economic environment for banks is less than ideal, with historically low rates pressuring margins, an over-leveraged Canadian consumer putting pressure on loan growth, and weak oil prices slowing GDP growth. Fortunately, Bank of Canada has strong exposure outside of Canada, specifically to the United States.

Currently, BMO obtains about 17% of adjusted net income from its U.S. Personal and Commercial segment. The actual proportion of earnings from the U.S., however, is actually higher. The bank has both Wealth Management and Capital Markets divisions operating in the country, and combined, the U.S. segments comprise about 24% of adjusted earnings.

This American exposure is important not only because it insulates a portion of BMO's business from Canadian-specific risk. It is important because macroeconomic conditions in the U.S. are extremely favorable for banking operations. Currently, the U.S. consumer is in the process of "re-leveraging", which means the U.S. consumer is adding more debt after significantly reducing debt during the recession.

This bodes very well for loan growth. Not to mention, the U.S. is nearly guaranteed to increase interest rates this year, which should increase net interest margins in the U.S.

BMO has a fairly low sensitivity to interest rate decreases

Not all banks are equally affected by drops or increases in interest rates. Some banks, for example, are poised to profit more than others when interest rates rise, and others are less negatively affected (and sometimes even positively affected), when interest rates fall.

BMO is poised to take advantage of a low-rate situation. It was recently announced that while the overnight rate dropped by 0.25%, the banks dropped their prime-rate (the rate they base loan rates off) by only 0.15% on average. This means that for some banks, their costs decreased by more than their revenue from loans, which could be positive for margins.

BMO is more suited than other banks to benefit from this. The reason, is because BMO has more wholesale and higher cost deposits than some other banks. These refer to deposits from other financial institutions, corporations, and governments, and banks typically pay higher interest rates on these deposits than deposits from individuals and small businesses.

Currently, about 61% of BMO's funding comes from these higher cost sources, and the costs of this type of funding will typically fall in close proportion to the overnight rate. This is in contrast to a bank like **Toronto-Dominion Bank** ([TSX:TD](#))([NYSE:TD](#)). TD has a has the highest percentage of demand and notice deposits to loans amongst the big banks, and these types of deposits are often very low, to no cost. This means that TD does not have as much flexibility to drop rates when the overnight rate falls since they are already close to zero (and the bank wants to remain competitive).

In turn, this means TD is more likely to benefit more when rise. With interest rates likely to remain weak, investors should consider BMO, as it is well diversified, can remain a strong performer in all environments, and currently has the highest yield of its Big 4 peers.

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Author

amancini

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