

Higher bond yields are good for banks, right?

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Higher bond yields usually mean bigger bank profits, but recent market moves tell a different story. We see banks' weakness as an investment opportunity.

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"Net, net, it's a positive for us" – that is how one global bank CFO described the impact of higher interest rates on the bank's earnings. The same CFO, and many others, would also quantify how sensitive the bank's income is to a shift in interest rates or the yield curve to estimate the potential uplift in earnings.

In September 2026, the US 10-year government bond yield rose to a 19-year high, posting its sharpest monthly increase since September 2022. Given that rising bond yields typically boost bank income, the recent moves should have ideally provided a strong tailwind. However, instead of rising with the yields, the global financial sector, including banking stocks, came under pressure and underperformed global equities.

This apparent contradiction highlights a more complex story at play. While higher bond yields can support bank revenues, several competing factors also create downside risks. Let us first consider where banks stand to benefit.

The upside from higher bond yields

Higher yields primarily lift bank earnings through wider net interest margins (NIMs). Banks can earn more on each dollar lent, and floating-rate loans can reprice upward quickly. At the same time, sticky deposit bases allow banks to pass on rate rises to savers more slowly, so margins widen.

In addition, a positively sloped yield curve – where longer-dated loans carry higher interest rates than shorter-dated loans – allows banks to fund themselves with short-term liabilities, such as customer deposits, and lend over longer periods through products such as mortgages. When the interest earned on these loans exceeds the cost of funding them, banks earn the margin. Importantly, any steepening of the yield curve can further widen this margin.

On the other hand, higher bond yields can pose risks as well.

The downside from higher bond yields

The most immediate hit is to the value of the bonds held by banks. Banks often invest their excess liquidity in bonds, whose prices fall as yields rise. The resulting mark-to-market losses could weigh on some banks' capital ratios. These losses remain unrealised until banks sell the bonds – which they might be forced to do if deposit withdrawals surge. The realisation of such losses risk triggering a need for fresh capital – or if capital cannot be raised, it threatens a bank's viability. Notably, these very dynamics were cited as one of the causes of several US regional bank failures in 2023 – a stark reminder that, for banks, customer confidence is critical.

Higher interest rates also increase borrowers' debt-servicing burden, which can raise loan-loss provisions and reduce banks' earnings. Higher rates can also lead to slower economic activity,

dampening capital market activity and the demand for loans. Lower loan volumes, in turn, create a drag on banks' interest income. Finally, if short-term yields rise faster than long-term yields, the yield curve 'flattens', narrowing the margin banks earn from borrowing short-term and lending long-term.

The current regional outlook and investment implications

With US bond yields having risen sharply over the past month to near two-decade highs, investors have become increasingly cautious about loan demand, capital buffers and funding costs. Yield curve dynamics have also shifted, with initial yield curve flattening (bad for banks) giving way to recent steepening (good for banks). Meanwhile, Euro area banks have faced additional headwinds from political and fiscal uncertainty in France.

The good news is that major banks remain well capitalised across the US, Europe and Asia. We believe sector fundamentals are largely intact and should continue to support strong earnings growth across the financial sector. We see particularly attractive opportunities in Euro area and Japan banks. For Euro area banks, a 'higher-for-longer' rate backdrop should extend the earnings upcycle. We also see earnings growth broadening to fee income. Combined with strong capital ratios and improving profitability, this backdrop supports higher dividends and share buybacks. Solid consensus earnings growth forecasts of 19% in 2026 and 12% in 2027, alongside reasonable valuations, strengthen the case for sustained sector performance.

In Japan, monetary policy normalisation by the Bank of Japan should drive NIM expansion, while a reflating economy boosts nominal loan demand. Corporate governance reforms – driving dividend growth and share buybacks – should enhance return on equity and support a continued valuation re-rating. Consensus earnings growth forecasts of 40% in 2026 and 16% in 2027 should provide further support.

As we embark on the Q3 2026 earnings season, we will continue to assess whether banks' earnings and underlying fundamentals can sustain their growth momentum into 2027. Results from major US banks so far have been mixed relative to investor expectations but still point to a resilient US economy supported by strong business investments and consumer spending. Capital market activities are growing, although some lofty expectations have to be adjusted. Overall credit quality continues to be manageable.

Key risks to this constructive outlook include unexpected and significant loan losses, a broader slowdown in economic activity and heightened geopolitical tensions.

Source: <https://www.sc.com/en/news/wealth-retail-banking/higher-bond-yields-are-good-for-banks-right/>