European Bank Equities vs. Bunds: A new chapter

The correlation between Bund yields and European bank equities did not play out exactly as expected in 2022. Though markets initially cheered the prospects of higher interest margins, investors were quick to exit the sector at the onset of the war against Ukraine. The energy crisis combined with a hawkish FED triggered fears that a deep recession in Europe was impending.

Despite strong quarterly results and constructive management guidance, the market believed that bank earnings would collapse in 2023 amidst a wave of defaults, higher costs, lower fees and negative loan growth. Sentiment started to shift in Q4: wages were picking up while supply pressures were easing; labor markets remained vibrant; central banks were starting to move more prudently. Unremarkably, the SX7R ended the year flat: the 20% rise in analysts' earnings expectations and 6% dividend yield were compensated by a drop in valuation multiples of a similar magnitude.

Looking into next year, the debate will gravitate around monetary policy and the strength of the labor market. European bank equities would do extremely well in a world of persistent low unemployment and high interest rates: margins would keep expanding while defaults would stay subdued. The question is, how patient will central banks be if core inflation stabilizes well above the 2% target? As Christine Lagarde said, "they are in for the long game". In our central scenario, after completing the first round of tightening, central banks will pause for a quarter or two and then start a second round of tightening, which will be longer and more progressive than the first one.

That said, there are many routes the economy could take, and it would be unwise to commit to a strong view on any single scenario. From a strategic allocation perspective, one needs to question whether it makes sense to be overweight the best performers of the last decade. There are several benefits from an exposure to European banks: they offer a high carry with minimal duration; their earnings are becoming less volatile; they have a key role to play in financing defense, energy, supply chains and climate objectives.

We explain below in more details why we believe the outlook for labor markets and nominal growth is strong, and why it matters for European banks. In a second step, we put ourselves in the shoes of a strategic asset allocator who wishes to diversify across factors in the context of elevated uncertainty.

To conclude, we set out our scenarios and price targets for the sector and discuss our positioning.

I. The consequences of a strong labour market

Labour market have defied all downturn expectations so far. On both sides of the Atlantic, unemployment is at an all-time low and wage growth is running hot. If that momentum is sustained, it would mean higher interest rates, low defaults and elevated credit demand for longer.

1. The outlook for nominal growth

Inflation is the result of an imbalance between spending and supply. Initially, the imbalance showed up in the goods sector: excess demand in goods came from generous fiscal programs combined with lockdowns, while the lack of supply was predominantly a matter of commodities, materials, logistics and factories. Today, the goods economy has cooled: commodity prices have tanked, supply chains are smoother, inventories have been rebuilt. Inflation is taking a different shape: there is an imbalance between the growth of nominal spending and labour, which is leading to strong wage growth. It has been evident for months in the US and the UK and is just starting to become apparent in Europe. Below are the median YoY estimated wage growth numbers as of November 2022:

US – Atlanta FED wage tracker	+6.4%
UK – average weekly earnings	+6.1%
Euro area – negotiated wages 2022	+3.8%
Euro area – negotiated wages 2023	+3.5%
Euro area – Indeed wage tracker	+5.1%
Germany – Indeed wage tracker	+6.9%
France – Indeed wage tracker	+4.7%
Spain – Indeed wage tracker	+3.8%
Italy – Indeed wage tracker	+4.1%

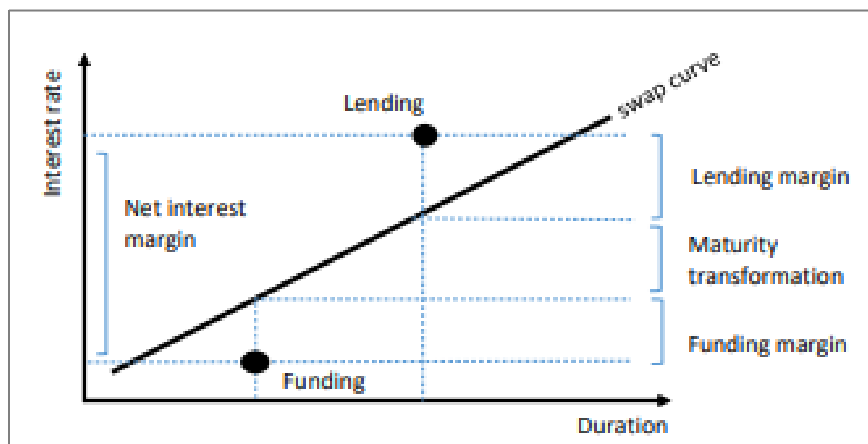
Strong wage growth is a powerful driver of nominal demand. However, there are notable counter currents that are leading many analysts to think inflation and growth will cool fast going into next year. The most obvious is the amount of monetary tightening completed so far. Interest-rate sensitive sectors such as housing or durable goods are struggling. The second string of arguments generally points to weak manufacturing and sentiment surveys. In the US, the weakness in the saving rate is also mentioned as a limit on future consumption.

Our belief is that wage growth will dominate the counter currents mentioned above:

- We do not believe 5% interest rates against a 7% nominal spending growth in the US (or in Europe, 3% interest rates against a 5% nominal spending growth) are sufficient to trigger a slowdown in labour markets.
- The trend in manufacturing may not be a good leading indicator due to the noise from the Covid lockdown/reopening cycle.
- Though low saving rates are clearly capping consumer spending growth in the US, in Europe they have remained high throughout 2022 and real excess savings have not come down.
- Sentiment surveys are highly correlated to the misery index (unemployment + inflation): in a high inflation regime, they are less reliable as a growth signal.

2. Banks' margins in a high nominal growth economy

Why does elevated nominal growth matter for banks? It means interest rates are high enough to allow them to capture a funding margin on their deposits. The simple diagram below illustrates the three components of loan-deposit margin: a funding margin (linked to the provision of deposit services), a lending margin (the spread earned by banks to compensate them for credit risk), and a maturity transformation margin (banks borrow short-term and lend medium-term).



Not so long ago, short-term interest rates in the Euro area were negative and curves were almost flat, preventing banks from making money on funding or maturity transformation (in fact the funding margin was negative!). Banks could only make money on the lending side. In 2021, the loan-deposit margin was about 150 basis points in the Euro area. Prior to the introduction of negative rates, it used to oscillate between 250 bps and 350 bps. In 2004 for instance, euro area banks used to lend at average rates of 4.5% while paying about 50 bps on overnight deposits and 2% on term deposits. A quick calculation shows that total household and non-financial corporate loans in the Euro area equal around 9x the tangible equity of the sector. Should the loan-deposit margin climb back to where it used to be, it would mean over 9 * 100 bps = 9 pts of additional pre-tax ROTE, i.e., a 60% increase in net earnings versus pre-pandemic levels. This extent to which banks will be able to increase loan-deposit margins remains to be seen; in any case, it is more likely than not that the potential revenues from rising rates are under-estimated.

High nominal GDP growth also means elevated loan volume growth as corporates need to finance more expensive inventories and investments. It has the side effect of making the stock of debt easier to repay, especially when the stock pays a low fixed coupon: in the 70s, loan losses remained low despite elevated unemployment. Importantly, the stronger the job market, the lower the loan losses.

On the flip side, higher wages would mean higher operating costs for banks. However, Europe is still overbanked and there are untapped efficiencies in retail networks and staff: the negotiating power of their employees is limited. Strong loan growth would allow to generate economies of scale and result in a net improvement in the cost / income ratio.

3. Could central banks kill the party?

This is an open question and a decisive one. If indeed nominal growth stays elevated into next year, with underlying inflation settling around 3% to 4% and wage growth around 4% to 5%, central banks will have to decide whether they want to stay patient and maintain rates at high levels, whether they want to raise them further but in small increments, or whether they wish to get rid of inflation once and for all by starting an aggressive second round of tightening. The second option seems the most reasonable and likely. That said, predicting central banks' behaviour is notoriously difficult.

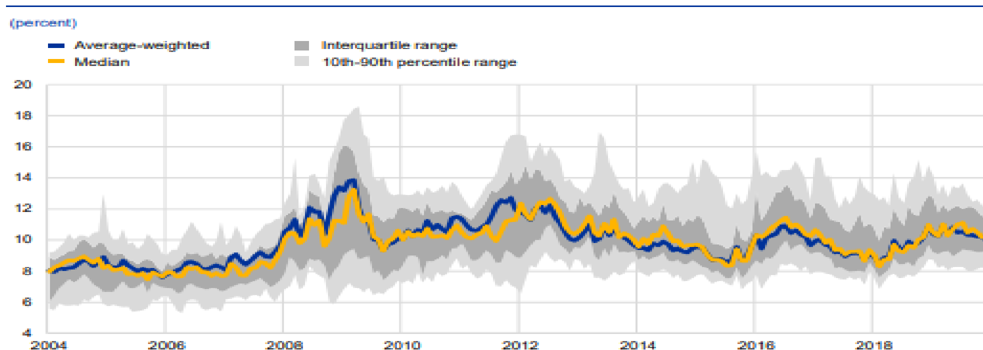
II. European Banks: the factor investing angle

The scenario described above is only one of the possible ways current macroeconomic imbalances may resolve. As navigating the present crosscurrents may prove tricky, one may wish to be agnostic to macro and balance exposure across asset classes and factors. The past decade has resulted in the domination of growth and quality sectors in market-cap weighted indices at the expense of value. Given the volatility in rates and inflation, it may be wise to seek a more equal-weight factor exposure. European banks offer a strong value tilt, while displaying under-appreciated quality and improving growth prospects.

1. Value: high carry with low duration

European banks are known to be cheap. The chart below from the ECB shows that under a range of valuation models, the cost of equity for the sector used to be around 7%-8% before the 2008 crisis and has been around 10% on average between 2010 and 2022. This compares to a long-term Equity Risk Premium of 4% to 6% for the S&P. In addition, European banks are characterised by high pay-out ratios, low growth and relatively low ROEs. It is not surprising that the sector often screens as the most attractive on a price-to-earnings, price-to-book or dividend yield ranking.

Cost of equity estimates for euro area banks using the model averaging approach



Sources: Bloomberg, Refinitiv, Kenneth French's data library and ECB calculations.
Notes: This chart shows the time-series of the model average estimates. EA is the euro area weighted average of the bank-level model average estimates, weighted by market capitalisation. The grey shaded area is the range between the 10th and 90th percentile of these estimates. Latest observation: December 2019.

Current valuations for the SX7E are especially attractive, in absolute terms and versus the broader European market. The current implied cost-of-equity stands above 15%. Over the past 10 years, its P/E ratio has been lower than its current level only 7% of the time. The price-to-book of the sector is still below its median level over the period despite a much-improved profitability outlook.

Metric	Current level	10 years quantile
Price-to-earnings	6.9x	7%
Price-to-book	0.60x	40%
P-E discount to the SX5E	41%	12%

The carry also stands at record highs: with a 7% dividend yield and a 3% buyback yield, the sector is set to return 30% of its market cap over the next 3 years. For some stocks such as UniCredit and Intesa, this number is north of 40%.

2. Quality: under-appreciated

In the 2010s, the profitability of the sector suffered from the triple whammy of an increasing equity base, forced de-risking and elevated restructuring costs. As a result, banks ended up screening poorly on a quality factor analysis. We believe the trend has reversed, with higher and less volatile ROEs going forward.

- *Excess capital:* Capital ratios are well above banks' internal targets. The impact of Basel IV has been in part frontloaded and will result in minimal headwinds going forward. Regulation is stable overall and broadly perceived to be slightly over-conservative. This allows for falling share counts and high pay-outs.

- *Loan losses:* The overall quality of loan books greatly improved: LTVs on mortgages are close to all-time lows, the share of Level 3 assets has shrunk, and banks have stayed away from the riskiest part of credit lending (private credit, CLOs funds and consumer finance Fintech sustained the growth of risky household and corporate debt). The drag from NPL de-risking stopped as NPL ratios have normalized and are back to pre-GFC lows.

- *Costs:* Banks have made significant progress with digitization. This is visible in the convergence between the ratings of incumbent and Fintech apps. Branch visits are now c. 30% lower versus pre-Covid. The proportion of banking transactions made online has accelerated. This allows banks to further reduce branches and staff. On the regulatory and ALM front, most of the heavy investment has been done. The shift from external consultants to internal staff will be another source of savings.

The benefits of the de-risking and restructuring undertaken by the sector are hard to disentangle from the macro picture. As a result, the quality thesis will need a full cycle to be tested. The performance of loan books in the next few years will be closely followed.

3. Growth: the capex super-cycle

In the aftermath of Covid, banks noticed a strong pick-up in corporate credit demand, both as a result of higher inventory financing needs and larger capital expenditures. The trend accelerated after the start of the war against Ukraine due to high financing needs for energy companies.

There are many reasons to believe a new capex super-cycle is shaping up:

- Reshoring and supply chain redundancy
- Energy security and climate-friendly solutions
- Building back better or levelling up infrastructure
- Defence spending
- Productivity investments linked to domestic labour pressures

The shift of capital and labour to Asia led to falling real wages and capital intensity in Western economies. The reversal of that movement could bring the reversal of its effects. All in all, banks will play a key role in supporting the return of capital and labour to western economies.

III. <u>Positioning for the year ahead</u>

As last year, we expect to see elevated volatility. After all, we still don't really know in which macroeconomic regime we are, and we do not yet fully understand how central bankers will react to different economic configurations. However, the risk of seeing a large drawdown is smaller. Most of the heavily lifting on rates has already been done. Inflation may prove stickier than expected but is unlikely to stay above 5%. The peak of the energy crisis is behind us. The entry point is more attractive, with the sector flat over 2022 despite a 20% increase in consensus earnings expectations.

1. What the next few earnings seasons may look like

The Q4 22 earnings seasons will start in late January for European banks. It is likely to look like a repeat of previous earnings seasons, with some inflexion around loan growth and cost guidance:

- On the asset quality front, defaults are likely to have remained very low throughout Q4. Analysts will probably push their loan loss expectations further back in time.
- Net Interest Income (NII) will again surprise to the upside, primarily for banks in floating-rate countries. Some fixed rate geographies such as French retail may look disappointing. Analysts will ask questions on the overnight vs. term deposits dynamics.
- Trading revenues will top expectations.
- Management will probably highlight lower loan demand, especially in the housing sector, but still point to healthy volume growth in 2023.
- Costs will probably be revised upwards as banks shift communication to a C/I target.

Should the current rates environment persist, the following earnings seasons will be dominated by NII momentum – which is severely under-appreciated assuming banks are able to restore their loan-deposit margins to their pre-2014 levels. Loan losses will be mainly a function of the labour market; given current excess provisions (around 30 bps i.e., enough to cover 70% of the typical recession excess losses), 2023 is probably going to look better than thought on the asset quality front.

In this environment, we favour banks with the following features:

- Business mix tilted towards retail NII, life insurance and trading, as opposed to asset management, brokerage and diversified financial services
- High positive earnings sensitivity to short-term rates
- High excess capital
- Cost-cutting potential and operational leverage
- We penalize CRE exposures, SMEs and sub-IG corporate exposures; in mortgages, we favour countries with low LTVs, lower house price risk and reduced household debt service stress.

2. Scenarios and price targets for the SX7E

To help frame the debate, we show below 4 scenarios that encompass a wide range of possible values for nominal growth and central bank reaction functions. For European bank equities, the "higher for longer" scenario would clearly be the most favourable outcome, while the "deflationary crash" would be the worst.

Scenario	Probability	Eurozone economic outlook	Central banks in late 2023	SX7E total return
Deflationary crash	10%	10%+ unemployment, <1.5% inflation	Aggressive rate cuts	-40%
Significant slowdown	30%	8%-9% unemployment, 1.5%-2.5% inflation	Progressive rate cuts	+10%
Higher for longer	50%	6%-7% unemployment, high but stable wage growth	Rates stable at a high level or slowly rising	+50%
Runaway inflation	10%	Wages are accelerating above 6%	Aggressive second round of tightening	-20%

3. Points of attention

Some Japanese banks - most notably Norinchukin, Japan Post Bank and Shinkin Central Bank – have high levels of interest rate risk and could be forced to sell assets should the Bank of Japan exit its yield curve control policy too fast. This could have an impact on CLO markets and sentiment on banks globally.

A deeper than expected decline in real estate markets could also have consequences on banks' asset quality. In this cycle though, the rise in house prices was not accompanied by a surge in mortgage debt: in Europe, over the last 6 years, house prices have climbed by over 40% but the ratio of mortgage debt to GDP remained unchanged. As a result, the share of mortgages with loan-to-value above 80% in banks' balance sheets is contained (~5% in the UK, Sweden and Ireland, ~15% in France, Italy, the Netherlands and Belgium).

Geopolitical risks remain elevated.

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Antonio started his career at Goldman Sachs Asset Management, where he focused on building optimal investment solutions for institutional clients with unique economic, regulatory and accounting constraints. He then moved to JP Morgan Asset Management, where he enhanced his insurance knowledge through the development of portfolio optimization tools under Solvency II.

Antonio joined Axiom in 2018 as a research analyst in the London office, where he supported PMs with insurance and banks coverage across the capital structure. **He has been managing Axiom European Banks Equity alongside David Benamou since January 2019.**

Antonio graduated from the **Ecole Polytechnique (X2012**) and the **ENSAE** (MSc in Statistics). He is a fully qualified actuary and holds the CFA and CAIA designations.

Main risks

Equity risk
Due to its investment objective, this Fund is exposed to equity risk. Therefore, its value may decrease when the equity market declines, especially when prices of financial stocks decrease.

Liquidity risk
Liquidity risk exists when particular investments are difficult to purchase or sell. This can reduce the Fund's returns because the Fund may be unable to transact at advantageous times or prices. This can be the result of shocks of unprecedented intensity and severity such as but not limited to pandemics and natural disasters.

Risk related to the use of financial futures instruments (IFT) - As the Fund, may invest in derivatives, the net asset value may fall more significantly than the markets and financial instruments underlying these products. The occurrence of this risk may lead to a reduction in the net asset value of the Fund.

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