EUROPEAN BANKING SECTOR :
RECORD DIVERGENCE BETWEEN MARKETS AND ANALYSTS

1. Decoupling of expected earnings and stock market performance

There is a rare divergence between the earnings expectations and stock market performance of eurozone banks. Analysts have been sharply raising their short and medium-term earnings estimates since the beginning of the year, while the markets have been sinking. The analysts' estimated ROE/(price/book) ratio has just reached the highest in the history of the SX7E, at 18x.

2. In the very short term (Q3/Q4 2022)

In the first half of this year, the results of European banks have positively surprised expectations. As a reminder:

- In the first quarter, revenues were 7% higher than consensus and profits 25% higher
- In the second quarter, revenues were 6% higher than consensus and profits 35% higher

This trend should continue for the rest of the year thanks to several performance drivers:

- Growth in outstanding loans (see ECB July and August data for national central banks).
- Improved margins (higher rates, higher risk premiums on corporate loans).
- Payment fees maintained at a high level on the thanks of good activity indicators.
- No slowdown in trading room flows.
- Slight recovery in the primary bond market.

- Default rate still below normal. However, there has been a slight increase over the last two months, particularly in the automotive subprime segment, but at levels that are still well below the medians.

3. In the medium term (2023)

Four variables will determine the ability of European banks to sustain their profits.

1. Credit production will a priori remain dynamic as long as core inflation remains (it follows nominal GDP growth). Banks have a strong lending capacity because they are based on solid fundamentals (high capital ratios, liquidity, and funding).

2. Analysts are still underestimating the effects of rate hikes on their revenues.

3. Markets are very negative on the economic outlook (see xover, cyclical companies' valuations etc) but employment, the variable most correlated with default rates, is not a source of concern, European banks' exposure to subprime segments is low and governments' fiscal policy remains protective.

4. There is a strong divergence of approaches between countries. France favours cooperation, Spain talks about introducing a two-year tax, central European countries have the most aggressive approach. The effect of super-profits taxes on the banking sector can be particularly sneaky, as the cost would have to be reflected into stress tests and loan pricing (that is the regulation), risking a withdrawal of the sector in a period of economic volatility. We therefore expect a more moderate and cooperative approach than might be the case in the energy sector (where super-profits are more shocking in extreme cases).

4. Relatively favourable context for banking values

In sum, it appears that the markets are excessively pessimistic, and are reflexively penalising the sector considering past deflationary recessions. In terms of strategy for the end of the year, our convictions are as follows:

There will probably be major short covering episodes given the particularly bearish positioning of hedge funds and global institutional players on European cyclical stocks.

Supply problems will become less of a concern and imported inflation will show signs of improvement: there is already a strong improvement in supply chains. There is also a sharp decline in commodity prices in several markets. There remains the acute problem of gas and electricity in Europe: it is difficult to make predictions, but one thing is certain: the worst has "almost" happened already (Russia has cut 70% of flows amidst a drought that has drained hydroelectric potential and a nuclear sector at a standstill - the energy black swan).

In any case, governments are likely to intervene to limit the impact of these strains on household and corporate finances. A wave of defaults caused by energy problems seems highly unlikely.

Core inflation will remain high - driven by buoyant employment and the diffusion of the past inflation shock to goods - and will show no signs of stabilising. Not much hope of a compression of risk premia via a return of the ECB "put" (which protects against demand shocks).

This should help the recovery of European cyclicals, at least relative to the market, but will not be enough for a strong overall recovery of risky assets (for that to happen, inflation would have to be on a more sustainable downward path). Banks will benefit from continued upward momentum on earnings expectations.

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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.**

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