

European Banks Equities, 2024 Outlook

With inflation running closer to target, central banks in advanced economies are poised to start cutting interest rates. The forward curve is discounting a return to a neutral rate of c. 2.5% in the Eurozone and c. 3.8% in the US. As we enter a new stage of the cycle, we discuss the opportunities we see across European banks equities.

Here are our 4 **main convictions**:

- I. The bulk of the rally in long duration is behind us.
- II. European banks equities should outperform the broader European market in all macroeconomic scenarios but a deep recession.
- III. If growth picks up, European banks should rally by 30%+ as their aggregate price-to-book jumps above 1.0 for the first time since 2017 according to our analysis.
- IV. High quality banks with resilient interest rate margins, strong capital generation and superior communication should outperform.

Data as of 12.31.2023

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I. The bulk of the rally in long duration is behind us.

Though one can be tempted to extend duration after the last rate hike has been delivered, the window to do so can be very short. When looking at the last 5 cycles, 10-year Treasury yields ended up on average one percentage point lower 3 months after the last hike by the Fed but did not rally further in the following 9 months. This time, duration appears particularly overextended. We had a record 120 bps rally in Treasury yields in just two months.

When looking at past cycles where policy rates ended up at a similar point to today, the average subsequent cut has been c. 140 bps. The forward curve is already anticipating a fall of a similar magnitude. Worse, when looking at past cycles that ended with a similar level of inversion, the subsequent steepening was 215 bps.

Through these lenses, the fair value in 10-year Treasury yields looks closer to the mid 4s than mid 3s.

Below is a table summarizing the option market implied view for where the 3M Euribor will trade in late 2024 with the associated macroeconomic scenarios. There is a less than 20% chance assigned to a persistence of high nominal growth. This leaves little room for the risk of a pick-up in either growth or inflation.

| Implied probabilities of Eurozone macro scenarios | | |
|---|-------------|-------------|
| Scenario | Rate | Probability |
| Deep recession in 2024 | -0,5% to 1% | 11% |
| Shallow recession in 2024 | 1% to 2% | 28% |
| ECB cuts due to low CPI | 2% to 3% | 41% |
| Higher neutral rate and good economy | 3% to 4% | 17% |
| Inflation comes back | Above 4% | 3% |

Source: Bloomberg data, Axiom analysis

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Though the progress in short-term inflation has been substantial, some caution is needed. Wages may be reaccelerating in the US: the Atlanta Fed wage growth tracker has stabilized above 5%; the NFIB Small Business Compensation Plans Index is back to 2 standard deviations above its long-term average; average hourly earnings and regional Feds’ wage pressure indices remain above historical levels. In the Euro area, the latest PMI publication highlighted that “charges for services meanwhile rose at a rate not seen since July” as firms were dealing with high wage pressures. The deflationary trend in goods will likely soon be exhausted as base effects disappear. Commodity prices, selling price for goods and supply chain pressure indices have been flattish over the last 12 months and they are already starting to bottom out.

In a nutshell, we believe the bulk of the rally in duration has already happened and that it is too late to pile on long-term bonds. Though short-term inflation prints may continue to look encouraging for a few months, medium and long-term inflation expectations have little room to rally further given the persistence of wage pressures, the end of the deflationary trend in goods and the slow but continued shift towards higher fiscal spend and fragmentation. In the equity space, we would caution against piling on the sectors that are seen to benefit from lower rates. Within financials, real estate, asset managers and retail brokers are likely to continue to face headwinds. Avoiding bank equities just on the basis that rates will be cut is misguided. They don’t underperform in an average rate cut cycle. Contrary to 2008, they outperformed both in 1992 and 2001 after the first cut:

| Share price performance of European banks relative to the broader market in past cutting cycles | | | |
|--|-----------------------|-----------------|---------------------|
| | September 1992 | May 2001 | October 2008 |
| T-6M | -1,50% | 6,50% | -6,00% |
| T-3M | 4,50% | -0,30% | 4,00% |
| T+1M | 1,50% | -1,40% | -16,00% |
| T+3M | 3,00% | 0,40% | -24,00% |
| T+12M | 10,20% | 9,90% | -6,00% |

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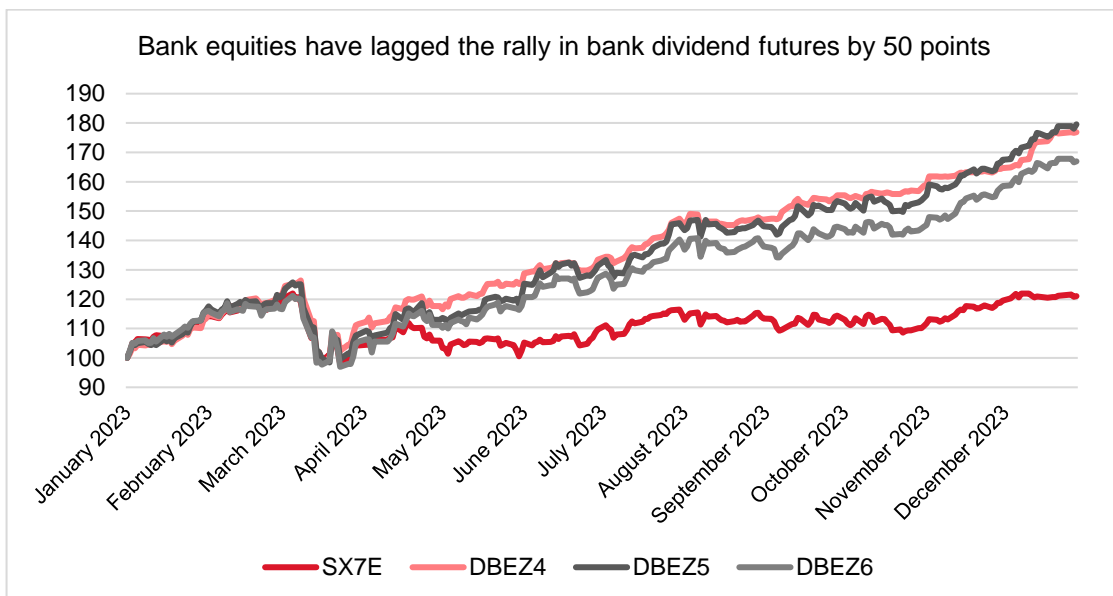
II. European banks equities should outperform the broader European market in all scenarios but a deep recession.

Sir John Templeton had a useful way to characterize the stages of a market rally: “Bull markets are born on pessimism, grow on scepticism, mature on optimism, and die of euphoria”.

While global markets have moved to an optimistic mood, European banks still face heavy scepticism.

There are many manifestations of investors’ caution regarding the long-term sustainability of current earnings:

- a. While SX7E dividend futures for 2024, 2025 and 2026 have climbed by 70% to 80% since January 2023, the SX7E itself has rallied by just above 20% in price terms.

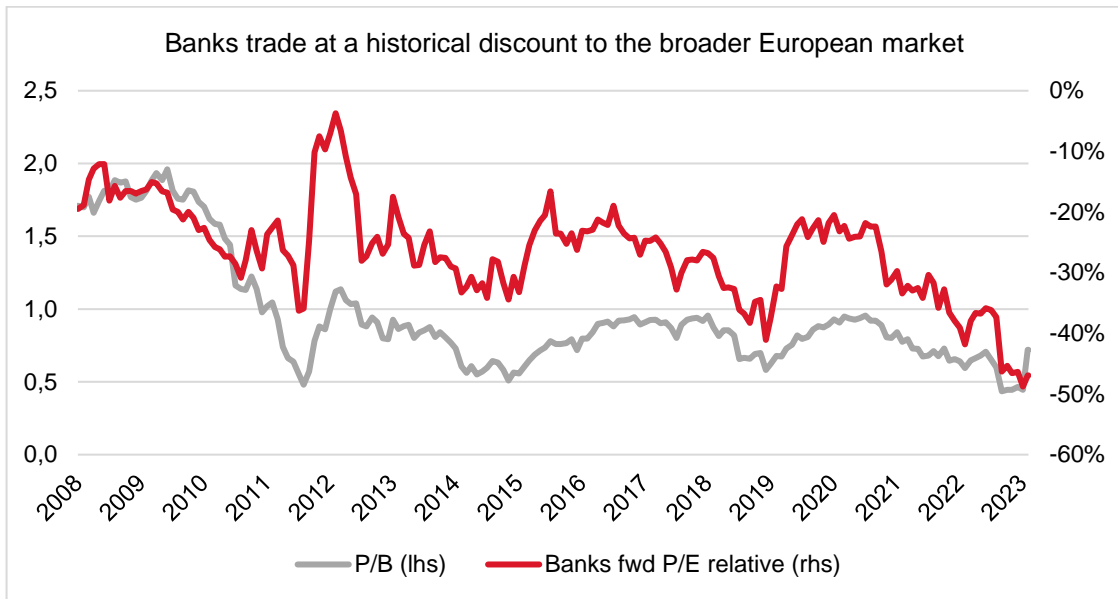


Source: Bloomberg data, Axiom analysis

- b. The 2-year forward P/E discount of banks versus the broader Stoxx Europe index is close to 50%, an all-time high.

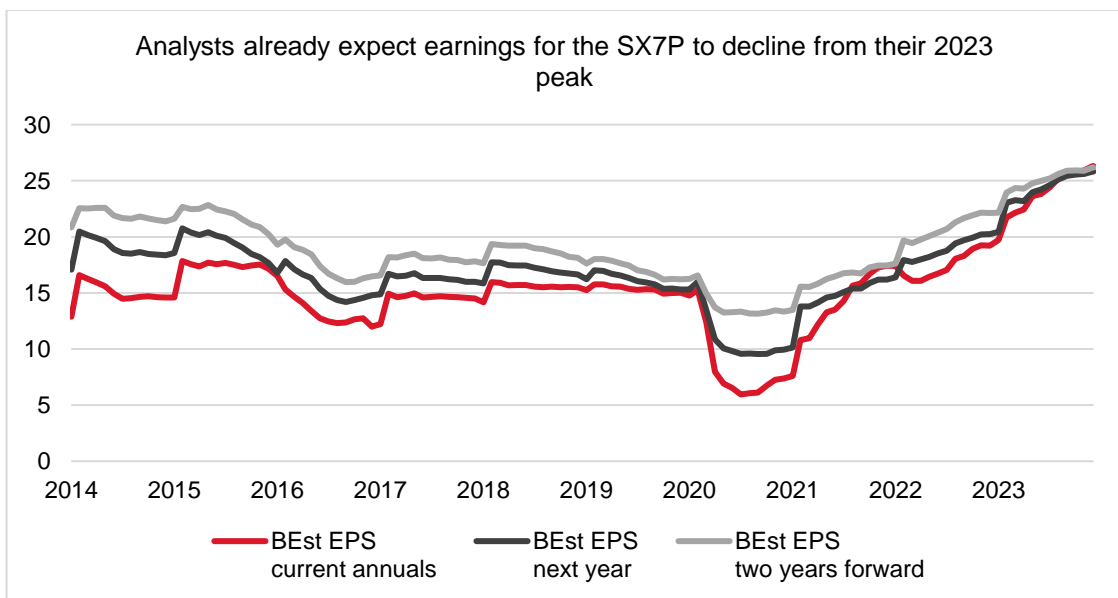
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- c. The consensus earnings expectations curve is inverted: analysts expect net income to decline by 4% in 2024 at index level on the back lower net interest income, higher provisions, and higher costs.



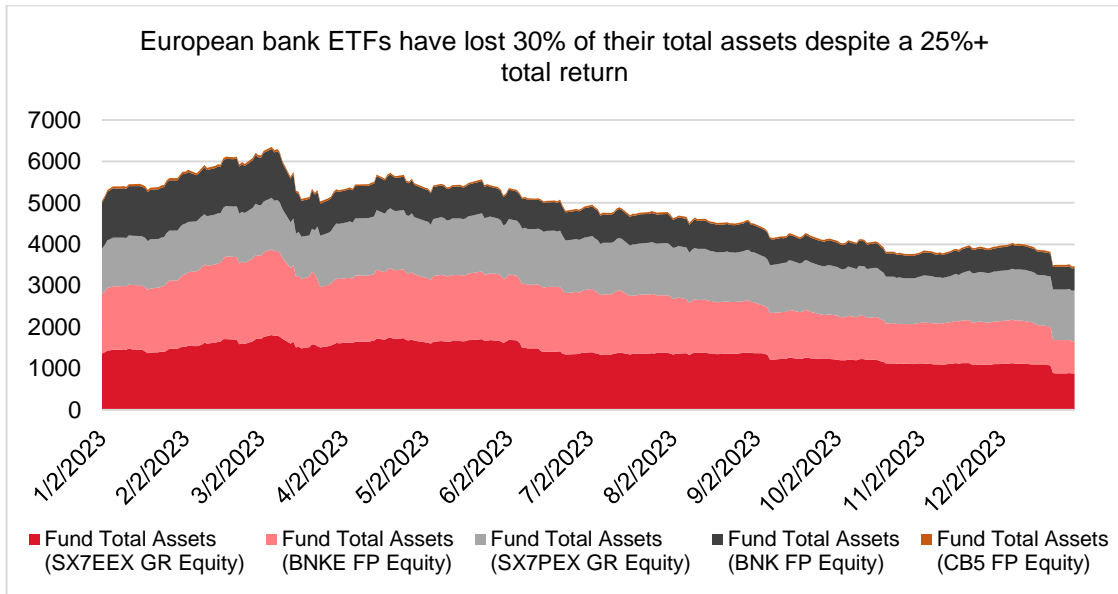
Source: Bloomberg data, Axiom analysis

- d. Flows in sector ETFs point to persistent selling and profit-taking in European banks this year. Several European bank ETFs have lost more than 50% of their total assets since

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the 2022 peak. While US banks have started to attract inflows again in the last 3 months, European banks are still in a small net outflow dynamic.



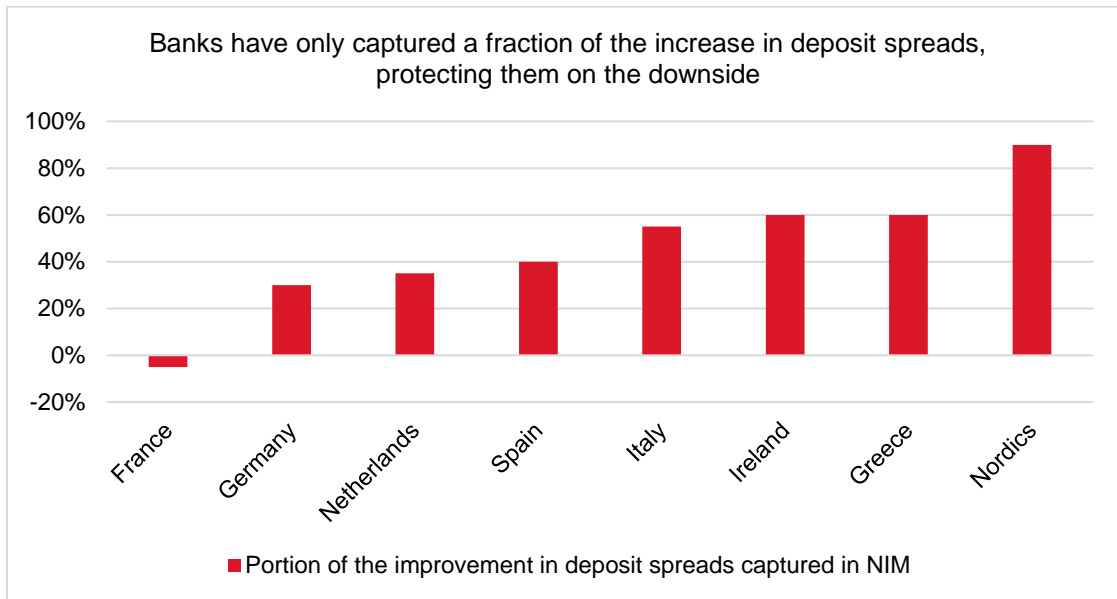
Source: Bloomberg data, Axiom analysis

We believe earnings will remain resilient with downgrade risk of less than 5% even if the economy stagnates and the ECB cuts rates back to 2% as implied by the forward curve.

- NII will be protected by replicating portfolios and general asset duration. The increase in sector NII so far only reflects 40% of the increase in deposit spreads, suggesting that banks have room to grow or maintain net interest income as margins on deposits normalise. In addition, deposit margins may stay higher for longer as deposit betas keep climbing more slowly than expected. We may see a peak in terming out activity as soon as the ECB starts cutting, with customers concluding that they missed the window.

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- Cost of risk will be mitigated by prudent underwriting, the use of precautionary provisions and state guarantees on risky corporate loans.
- Banks will pass increases in employee compensation onto fees and mitigate cost growth through prudent hiring and tactical restructurings. Consensus expectations for compensation growth entails persistent wage pressures, which is at odds with the assumption that ECB will cut aggressively.
- Increased buybacks will support EPS growth.

Hence, we believe that the sector will trade well in 2024 as modest earnings cuts if any are compensated by stronger macroeconomic visibility, higher confidence in the earnings outlook and strong shareholder distributions.

Though it may seem odd to argue for a re-rating of the sector at a time when EPS are at a risk of being slightly downgraded, this follows an unusual period of very strong earnings momentum and declining valuation multiples, with the decoupling more extreme than prior to the GFC. In a year where the economy keeps stagnating and the ECB cuts rates as implied by the forward curve, our base case is that banks will slowly climb a wall of worries and grind higher as

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earnings stability and shareholder friendliness provide comfort on the sustainability of current yields.

To state the obvious, whether 3M Euribor settles at 1.5%, 2.25% or 3.0% it should be remembered that either outcome is much better than the sorts of rate expectations which investors regarded as likely as recently as the start of 2022 or during the NIRP era (50 bps at best). Leaving behind NIRP has been a sea change for European banks' profitability, and the end of the regulatory cycle has led to higher payout ratios, which should translate in higher multiples. It does not make sense for the price-to-book of the sector to still trade below the median level of the NIRP era.

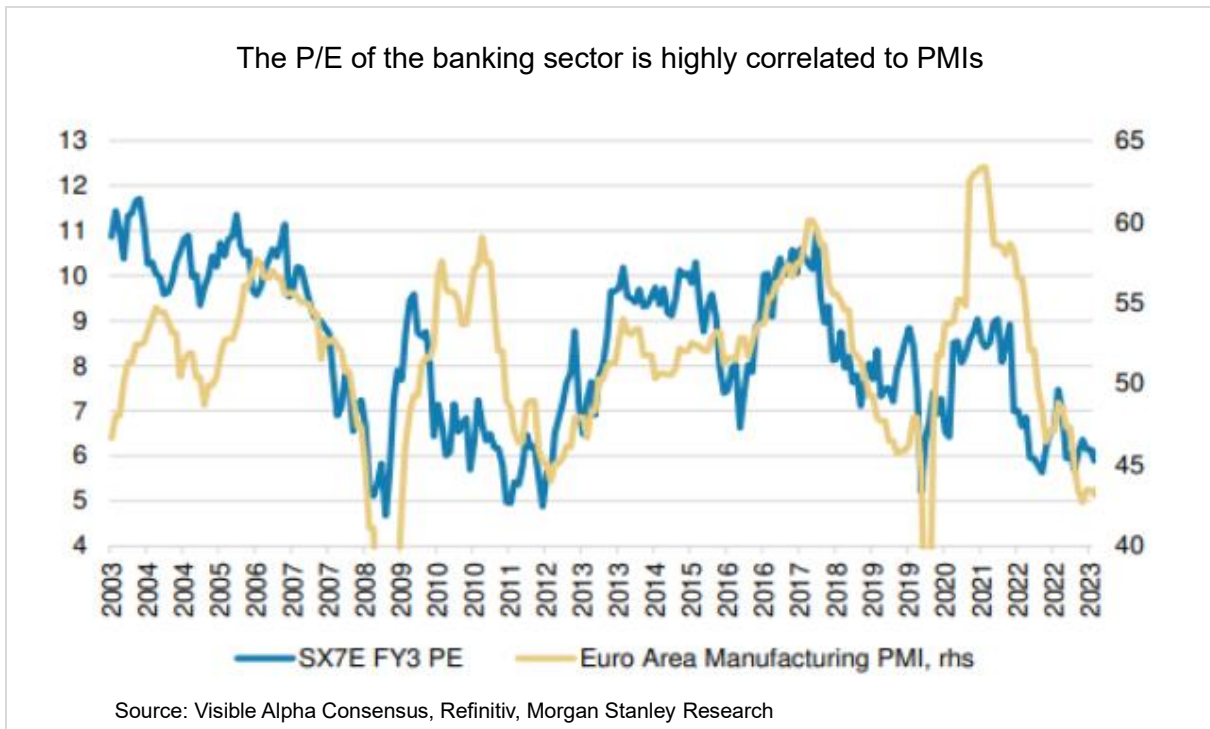
In the short-term, the Q4 season is likely to bring positive surprises as the cost of deposits has grown less in aggregate than modelled and higher capital buffers translate in additional shareholder returns.

III. If growth picks up, European banks should rally by 30%+ as their aggregate price-to-book jumps above 1.0 for the first time since 2017.

The PE ratio of banks has historically been highly correlated with PMIs. Strong bull markets in banks have often coincided with an improvement in economic prospects and a steepening of the yield curve. In our base scenario above, we assume that macroeconomic conditions remain cloudy, with weak or slightly negative growth, somewhat inverted yield curves and poor credit demand, and that multiples stay low.

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This might prove overly pessimistic. On the growth front, Europe has been dragged down in 2023 by an exceptionally high saving rate, negative credit creation and weak exports. This could turn in 2024 as higher real wages and declining short-term interest rates revive spending and corporate credit. In a scenario where PMIs climbs convincingly to 52+ levels, flows would come back to the sector and drive earnings multiples back to their long-term average.

This would imply a rally of over 30% in price terms, which would bring the sector aggregate price-to-book above 1.0x for the first time since 2017.

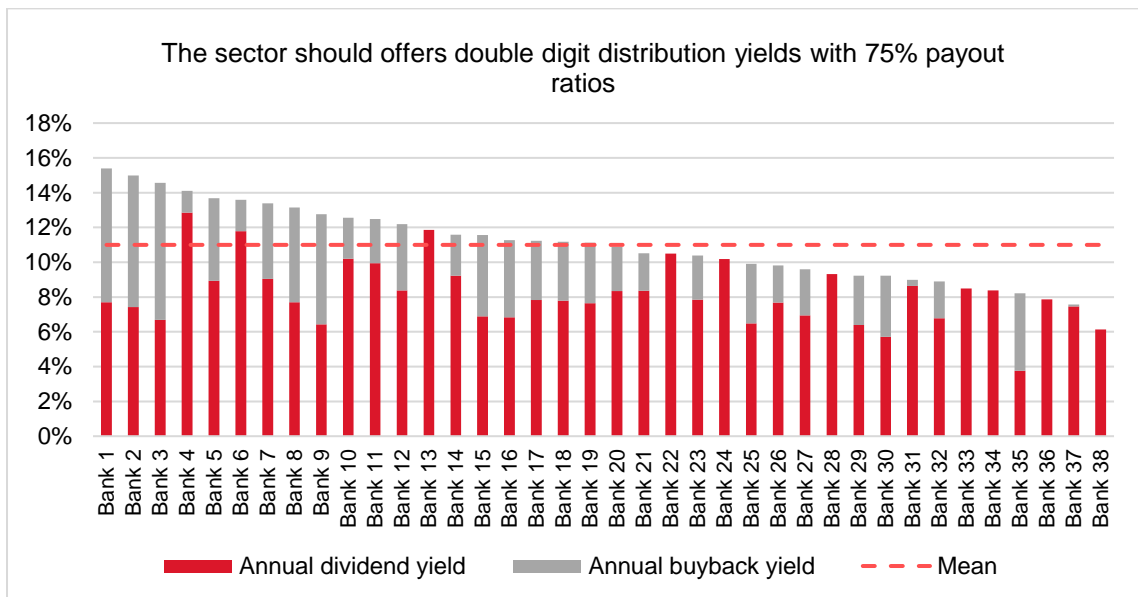
IV. High quality banks with resilient interest rate margins, strong capital generation and superior communication should outperform.

In a cloudy macroeconomic environment, we believe that quality will pay off. We would favour models that offer a combination of:

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- 1- Earnings resilience in a 1%-2% rate environment: We prefer banks that are not too pressured by declining deposit spreads and would benefit from a steepening in the yield curve as well as a rebound in loan demand.
- 2- High and sustainable shareholder distributions: We do not expect a revolution from the new chair of the SSM. We would expect faster and streamlined SREP and buyback approval processes to be a net positive. Furthermore, in its November 2023 review of financial stability, the ECB acknowledged for the first time that regulatory uncertainties in terms of distribution were deterring investors from this sector, which is likely to fuel systemic risk via low valuation. We see some pressure on banks with weak data, governance, or organization. Banks that can achieve higher sustainable payout ratios should rerate more. In terms of near-term catalysts, we expect updates on capital return policy from ABN, AIB, Bank of Ireland, Deutsche, Sabadell and UBS with Q4 results.



Source: Bloomberg data, Axiom analysis

- 3- Superior visibility: Banks that will successfully anchor expectations through superior communication will command a premium as interest rate volatility remains high. Exposures to CRE and high-risk corporates should be avoided.
- 4- Ability to deliver growth in a weak economy: We expect geographies with stronger growth outlook such as CEE to command a higher premium as overall growth in Europe

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will be scarce. Payments could offer an area of growth as banks regain market share. Insurance should do well, and we might see inflows back into guaranteed products in case of rate cuts. We remain sceptical as to a broad rebound in capital markets, M&A, retail brokerage or alternatives.

In terms of single names, according to our analysis, KBC trades at the low end of its historic P/E range and it is exposed to growth in the CEE region and would be supported by its replication portfolio. BNP offers revenue diversification and should be resilient in a falling rate environment and will benefit from the redeployment of the Bank of the West capital. Most of rate sensitive banks should continue to offer great value and distribution yields.

As always, navigating tactically the excessive extrapolation of short-term trends will generate alpha. The recent under-performance in some periphery names seems exaggerated and we are adding back to the segment ahead of Q4 results. We expect to see significant dispersion and mean-reversion throughout the year as the market oscillates between different landing scenarios.

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Antonio Roman

CFA, Qualified Actuary

Portfolio Manager

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.

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