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Markets

European banks: why investors should still be choosy even as prospects brighten

Bank shares have been supported by expectations of higher interest rates but these could take some time to materialise. We prefer banks that are less reliant on the rate backdrop and note UK banks look attractive for patient investors.

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Unstructured Learning Time

We remain selectively constructive on the pan-European banking sector.

Capital levels and bank profitability continue to build, the global economy is strengthening and, at least in the US, interest rates are rising with the hope that Europe and even the UK could follow.

Regulatory headwinds are abating (with the potential that they may even turn into tailwinds, led by the US) and geopolitical risks feel diminished.

Higher rates still some way off

The “rising tide” of the global reflation trade has lifted much of the sector over the past year. One has to be conscious that this could abate should higher rate expectations get pushed out.

Furthermore, investors need to understand that the impact of the withdrawal of monetary stimulus on many of Europe’s banks, as and when it arrives, will be rather more nuanced than commonly assumed.

For euro area banks in particular, higher interest rate expectations have been a key driver of positive share price performance over the past year. However, core inflation remains subdued and wage growth muted despite strengthening GDP and falling unemployment.

There is therefore a risk that interest rates could remain at extremely low levels for many years to come, even as the economy strengthens.

Preference for those banks not reliant on rate rises

Our approach is to favour banks which have the potential to deliver attractive returns whatever the rate environment. The speed at which banks can reprice their balance sheets and adapt their cost bases varies markedly across Europe.

For many banks, the anticipated earnings boost from higher interest rates stems in large part from the transitory benefit of subsidised European Central Bank (ECB) funding via TLTRO2

(targeted longer-term refinancing operations).

Meanwhile, the higher long-term rates which would accompany ECB tapering will prove negative for profit margins and capital. This will come as term funding costs rise and as the value of bonds held on bank balance sheets falls.

As and when the ECB chooses to roll back the comfort blanket of monetary accommodation, such details will matter.

A few banks still need balance sheet clean-up

The banking sector is far from uniform. Most banks in the pan-European universe have relatively clean balance sheets, but some – in Italy and Spain in particular – have more work to do.

Furthermore, the profitability of banks – even on an assumption of normalised credit losses – varies markedly, as does the predictability of earnings.

The majority of banks have now rebuilt capital to levels which incorporate a reasonable buffer against the unexpected. However, the capacity of banks to continue to build capital - and so fund growth, pay dividends, absorb unanticipated shocks and accommodate regulatory pressure - varies markedly.

A small but awkward cohort of banks still needs material further restructuring efforts to lift profitability to levels where value is no longer destroyed.

ECB may increase scrutiny

As the recent failures of Banco Popular in Spain and Veneto Banca and Banca Popolare di Vicenza in Italy demonstrate, this remains a sector where investors need to tread carefully. When large underprovided problem loan balances collide with an inadequate capital base, both equity investors and bondholders are at risk of material loss.

Thankfully, the number of problematic banks continues to diminish. Nonetheless, we see a very high chance that the ECB steps up both the intensity of its scrutiny of provisioning adequacy and the pace of required balance sheet clean up.

This would likely be to the detriment of earnings and possibly share count for a minority of Europe’s quoted banks.

Rewards may outweigh risks in the UK

Meanwhile, in the UK, the equity market seems to be applying an ever higher risk premium to UK domestic banks. A weakened government, slackening GDP, high consumer indebtedness and Brexit-related uncertainties present an unpalatable cocktail of concerns.

To be sure, there are risks, but part of our job as investors is to judge when the potential rewards more than justify those risks.

The fact that the Bank of England’s Financial Policy Committee has signalled that it expects to increase the countercyclical buffer to 1% by November next year (seen as the appropriate level for a “standard risk environment”) should offer some degree of comfort for investors.

With domestic UK banks all screening comfortably at the cheaper end of the sector, we believe there is a high chance that patience could be well-rewarded.

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