EUROPEAN BANK EQUITIES:
STRONG EARNINGS OUTLOOK, WEAK SENTIMENT

In defiance of the prevailing pessimistic mood, European banks had an excellent start to the reporting season. On aggregate, **revenues were 7% higher than expected** - the strongest positive surprise in years - while earnings were 25% better. On a Y/Y basis, revenues grew by more than 8%. Net interest income was supported by dynamic lending book growth and stable or increasing margins. Costs were in line overall, which came as a relief in the current environment.

There was no evidence of deterioration in asset quality: non-performing loans continued to decrease, and defaults remained significantly below average. Banks nonetheless took precautionary provisions in light of geopolitical and monetary policy risks. Capital ratios took a transitory hit from mark-to-market losses in bonds not accounted at cost.

As analysts revise their expectations for the year upwards, the sector keeps trading at depressed levels. **The SX7E is valued at 6.7x next year earnings** (and 5.9x 2023 earnings), which contrasts with a median level of 9.0x and a maximum of 12x over the last decade. Only twice was the P/E lower: in the middle of the 2011/2012 Eurozone crisis and at the onset of the pandemic.
Why the disconnect between fundamentals and valuations?

There are two sets of developments that are unsettling markets:

i. Higher commodity and supply chain costs are **eroding purchasing power** and **consumer confidence** (the Putin + Xi Jinping risk)
ii. The **risk of a wage-inflation loop** may drive central bankers to slam the brakes on growth by raising rates to contractionary levels (the Bullard + Knot risk)

Though uncertainty is high (the prime example is the possibility of Russia cutting gas supply), our central scenario remains an **optimistic** one: we see growth in services sustaining employment and spending trends; we see a progressive improvement in commodity and supply conditions as extraction and production capacities are rebuilt; we see central banks not willing to risk a contractionary spiral to fight supply-driven inflation.

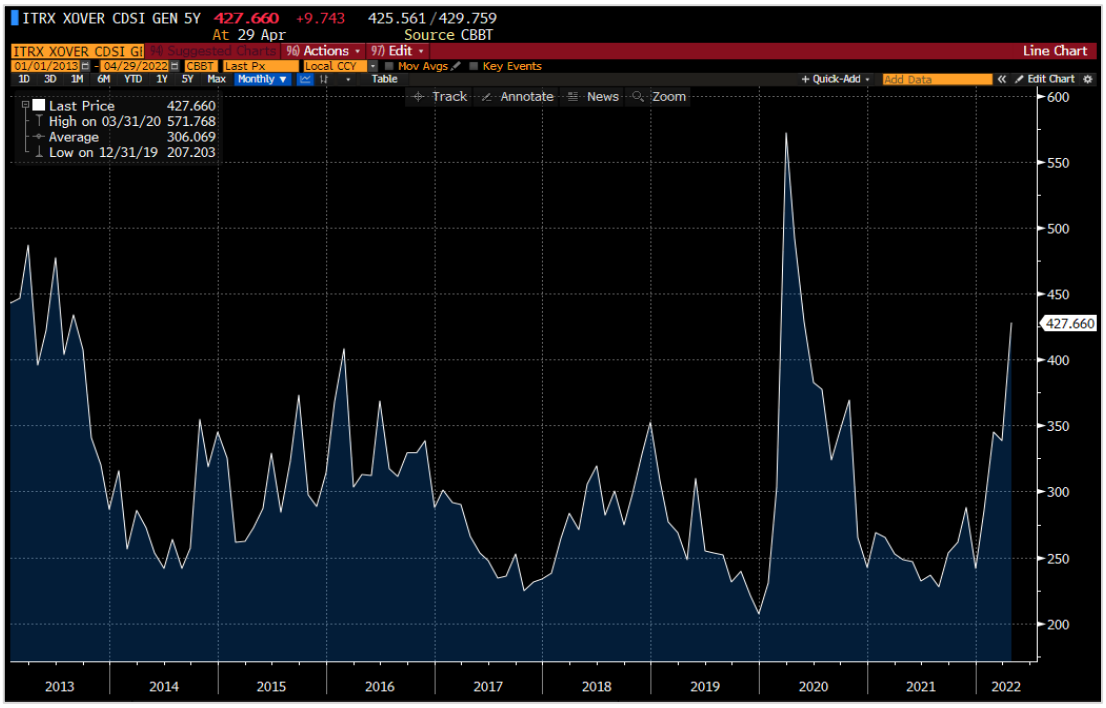
In short, we deem it **unlikely that the current supply shock will morph into a demand one**.

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1. Markets are pricing high odds of a prolonged growth shock

Risk premia have increased across the board and are now at average recessionary levels.

1. European HY spreads are back above 2016 and 2018 highs



Source: Bloomberg

2. Banks are trading at depressed P/E levels, especially relative to the broader market

As evidenced by the chart below, bank's forward P/Es are half their maximum levels and close to their minimum levels (≃6x). Relative to the broader market, they are trading at a 45% discount (the discount has oscillated between 15% and 53% over the past decade). Sentiment on banks could hardly be more negative.



Source: Bloomberg

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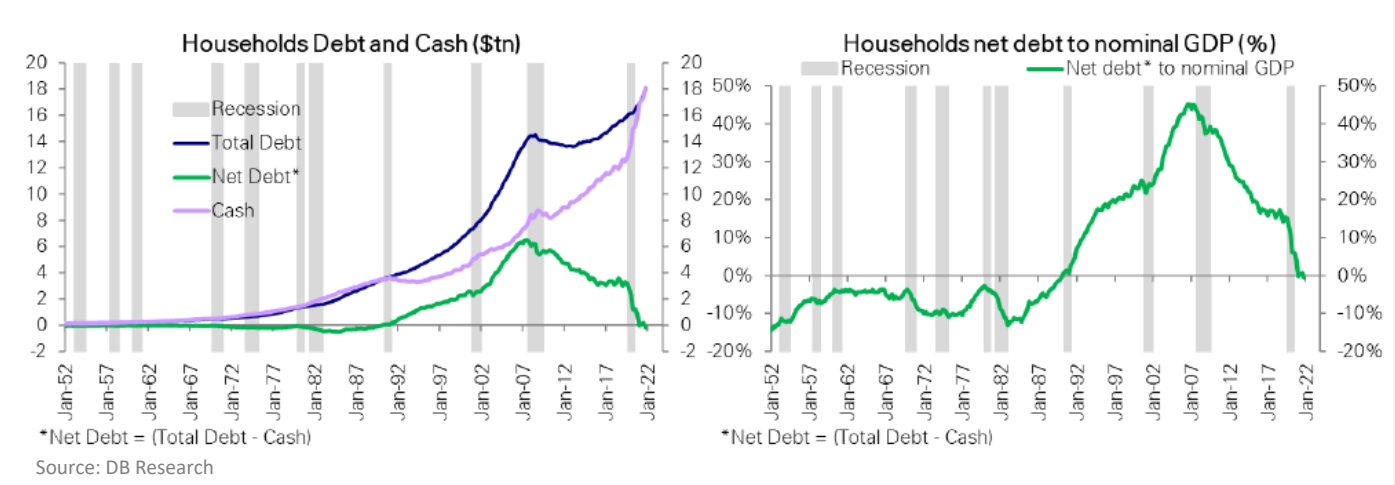
What does this tell us?
The market is skeptical that the Eurozone can achieve what economists and central banks currently forecast, i.e. **real GDP growth of 2.5%-3%** in 2022 and 2023 and **unemployment rate stabilizing below 7%**. It prices high risk of a demand slowdown induced by loss of purchasing power and hawkish central banks while betting that customers and corporations will cut spending, economies will enter into a recession, defaults will rise and credit growth will stop. Are these fears confirmed yet by economic data?

2. Fundamental economic data sends conflicting signals but still suggests sustained expansion

There is a wide range of economic indicators that are worth looking at. We will focus on **consumers and corporate balance sheets, real spending and savings rate, PMIs, employment, and credit growth indicators**.

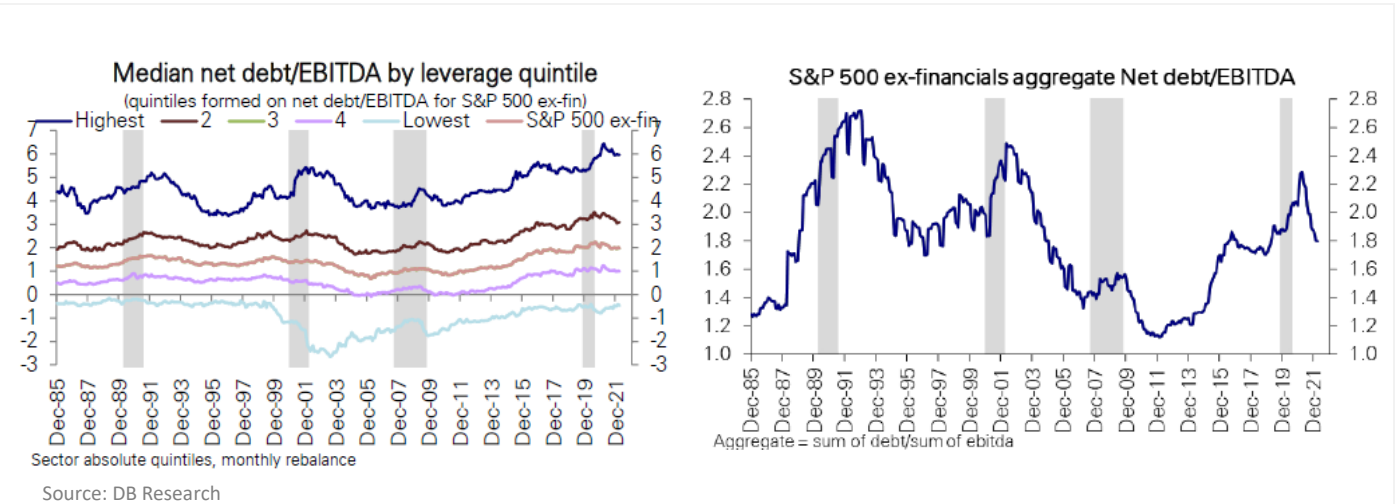
1. Consumers and corporate balance sheets

Economic agents have been able to accumulate cash and wealth thanks to public to private pandemic transfers and soaring property prices. DB noted that at the start of the year, household cash exceeded debt for the first time in 3 decades:



Source: DB Research

Similarly, non-financial corporations have been able to stabilize leverage, except for the most levered quintile (which constitutes a lower share of total debt than in the past):

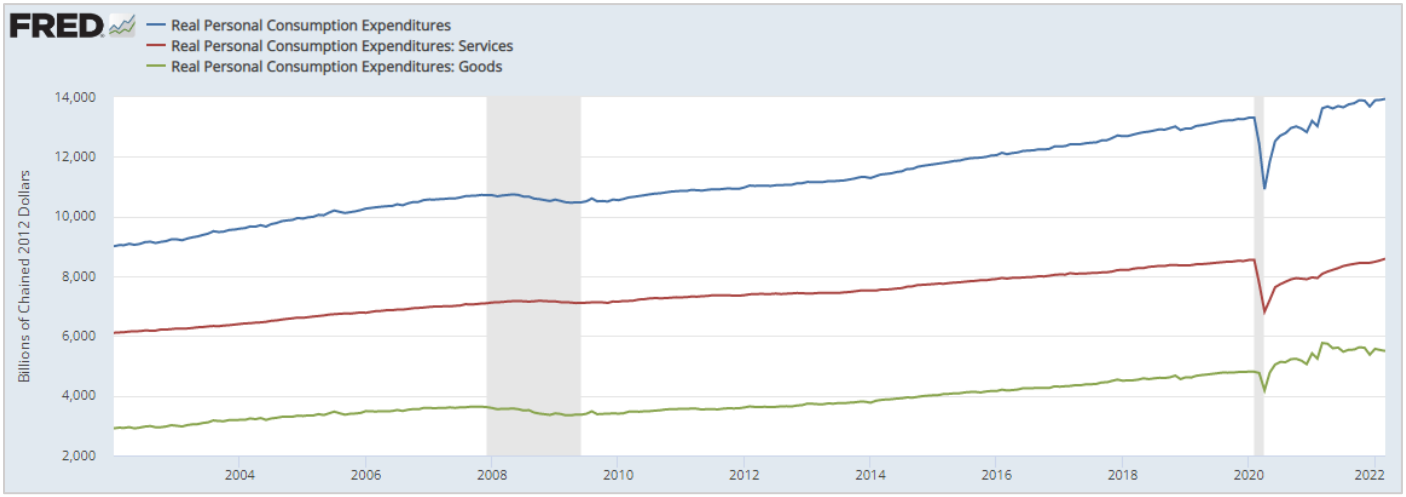


Source: DB Research

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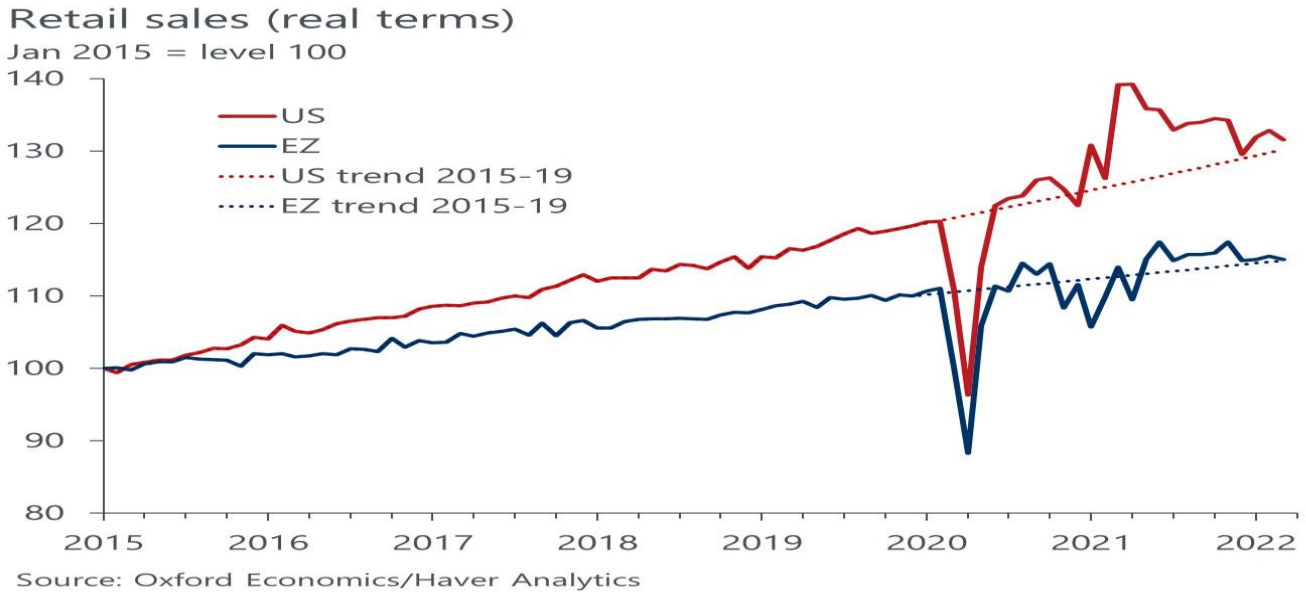
2. Real spending and income

Higher commodity and goods prices have put a strain on consumers' spending power and eroded the value of their accumulated savings. Increases in the workforce and wage hikes have not been sufficient to compensate for cost-of-living inflation. As a result, real incomes are (moderately) down.
However, real spending has held well, at least in the US. This is probably due to the exceptional amount of savings accumulated over the pandemic: **$2.3trn in the US and over $1trn in the EU.** As a result, consumers can afford to sustain a lower-than-average savings rate for a long period of time.



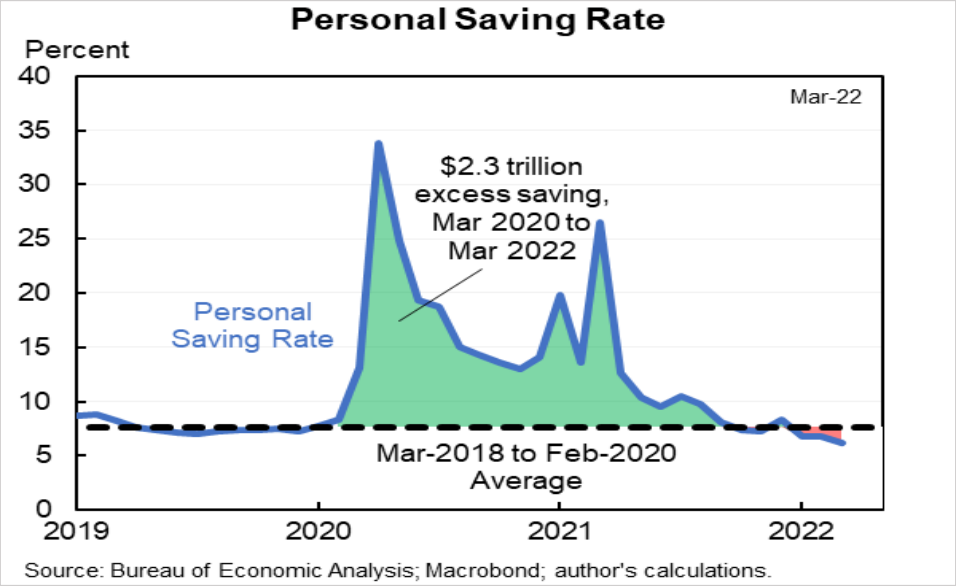
Source: Bureau of Economic Analysis

Real consumption patterns evidence a loss of momentum in goods consumption after an unusual above-trend jump during the pandemic. This is materialized through disappointing retail sales and industrial new orders. Zooming-in below, we observe that we are now almost back to trend. It is very possible that real goods consumption goes temporarily back below trend to compensate for earlier over-spending. However, it does not necessarily mean that the economic momentum is weak or that consumers are more careful now. It could simply suggest a normalization of consumption patterns with consumers spending more time outdoors.



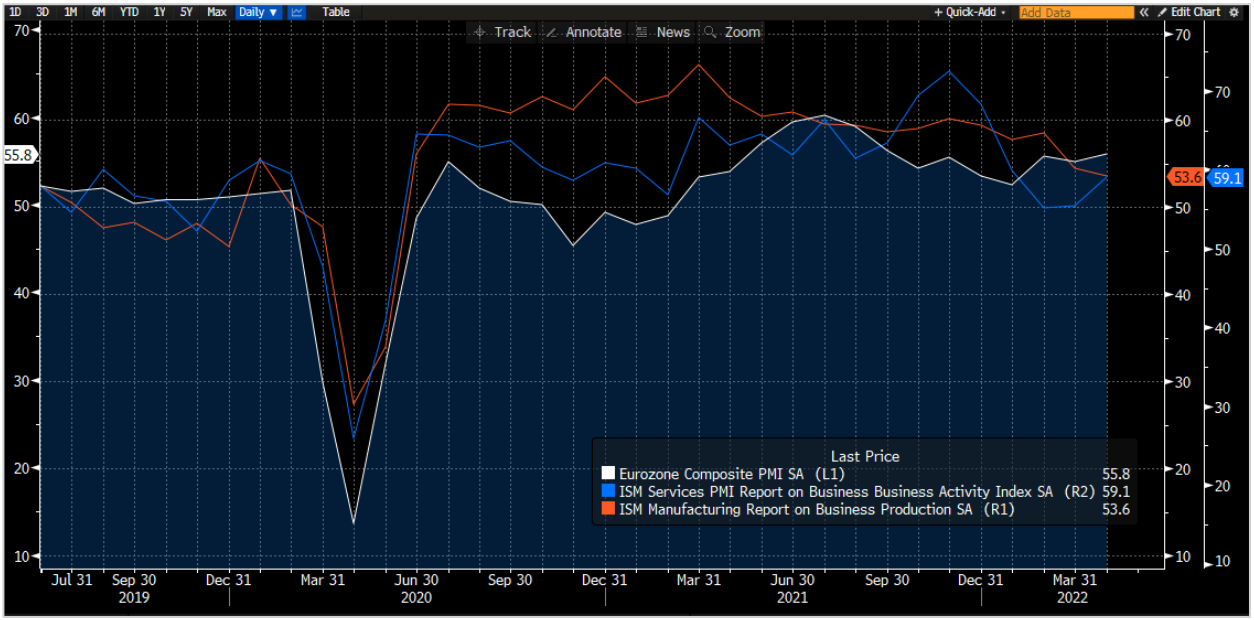
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Future strength in consumer spending relies heavily on their ability to sustain higher prices. The chart below shows that US consumers have barely started to "tap their savings": despite current prices, the savings rate is still at 6.2%, a low level but not shocking, corresponding to the 43% percentile of the historic distribution. So, below media, but sustainable. In Europe, we don't have up-to-date metrics on savings, but December 2021 savings rate was still well above its average, suggesting consumers also have barely started, if at all, to tap into their savings. A lot will depend on the evolution of commodity prices and supply chains.



3. PMIs

Service PMIs data has been strong as Covid restrictions were lifted and consumers increased their spending on outdoor activities. Manufacturing PMIs have been more mixed, signaling **low** or zero **growth** in new orders.
Deriving interpretations at this stage is not easy: one cannot really tell whether the loss in manufacturing momentum is due to consumers shifting their spending to services or to the loss of purchasing power due to inflation. Importantly, services make up above 70% of advanced economies and composite PMIs are consistent with 2% to 3% growth on both sides of the Atlantic. In Europe, April Composite Output Index PMIs signaled the strongest expansion in 7 months.



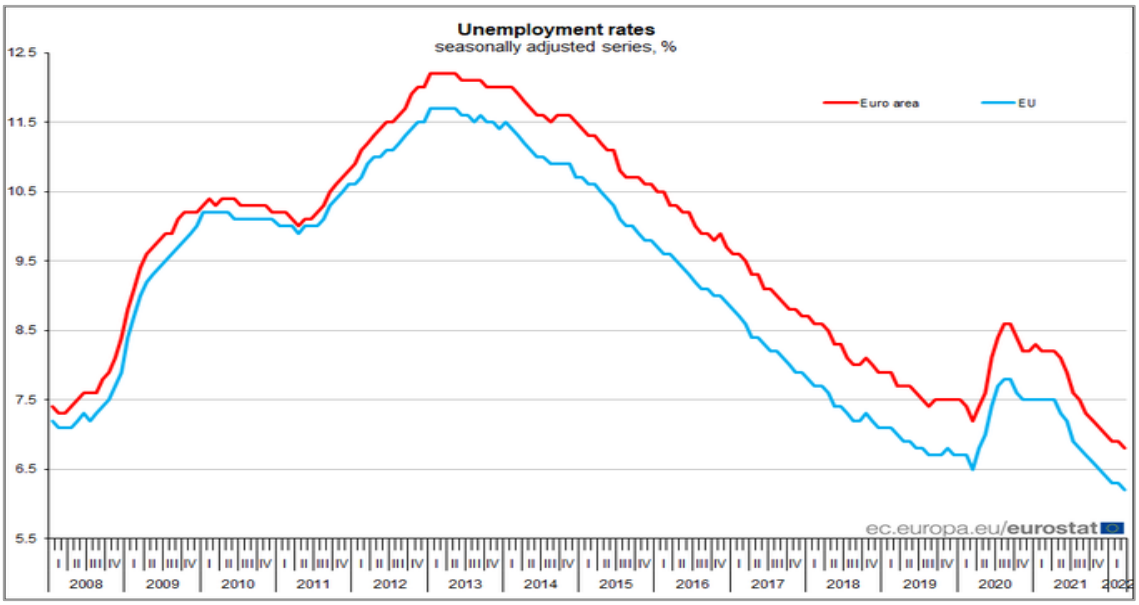
Source: Bloomberg

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4. Employment

Labor markets are hot on both sides of the Atlantic, with the number of vacancies at record highs and the number of layoffs at record lows. In the US, the workforce is still below pre-pandemic levels: some workers have not been willing to return to work, causing major difficulties with hiring and pushing salaries higher.

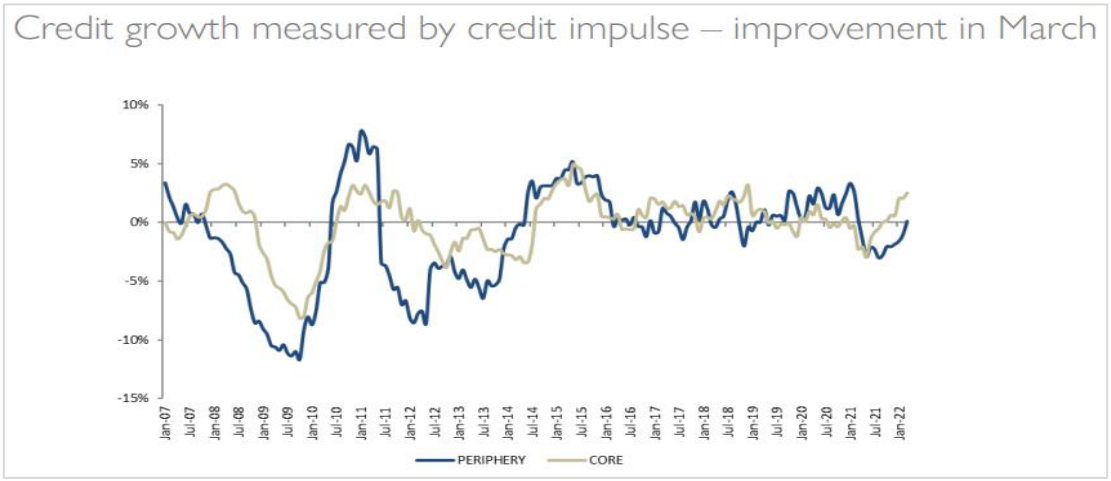
In Europe, the workforce has risen above its pre-pandemic level, in part thanks to work retention schemes. Salaries have been growing moderately, at or below their pre-pandemic average pace. Unemployment rate is still high in absolute terms, which suggests room to grow, though is also symptomatic of structural inadequacies.



Source: Eurostat

5. Credit growth

Credit demand has been strong in the last few quarters owing to the need to rebuild inventories, catch up on investments, higher house prices and rebounding consumer credit. The credit impulse (the change in net annual new credit) turned back to positive levels, after it briefly turned negative due to the reimbursement of government-guaranteed loans. Current bank credit growth is trending around 5% to 6% in nominal terms.



Source: ECB, Autonomous

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Nominal deposit growth accelerated in Q1 2022 to reach an annualized rate of 5.5%. The strength in nominal terms has allowed real money growth to stay positive despite very elevated Y/Y inflation. Overall, there is no slowdown in credit at this stage that is susceptible to lead to a recessionary loop.
However, central banks tightening policies are likely to result in slower money growth, leading to a real monetary contraction. Whether central banks will go as far as to trigger a recession is the $1trn question. Right now, the real rates curve is low enough to allow for a continued expansion of the credit cycle, though nominal rates are high enough to weaken non-profitable businesses.

6. Conclusions

A few high-level conclusions can be drawn from current economic data:

- Economic agents started the year with **record wealth and liquidity,** setting the backdrop for **strong potential demand**. Today, high imported inflation (commodities and supply chains) has eroded purchasing power somewhat, but not enough to undermine demand. Financial conditions have tightened somewhat, but the real rates curve remains low enough to support aggregate lending. The economy continues to be shouldered by expansion in services and the workforce.
- The future path of energy prices and supply chains will be critical: an easing of **supply conditions will result in more sustainable demand and a likely rosy outlook;** a tightening will increase the chances of triggering a recessionary loop; if they stay as they are, the economy will probably be able to expand at an honorable rate, though not as high as previously thought.
- **Also critical will be the path of interest rates**. The market is currently pricing somewhat hawkish central banks, but overall financing conditions remain accommodative. Should real rates keep climbing, this could put a serious brake to credit creation and trigger a reversal in the wealth effect - particularly through property prices. Our take so far is that central banks are committed to return to "normal" as fast as possible but are not ready to fight inflation "at all costs"; prudence will likely prevail, with any sign of weakening demand likely to induce a slowdown in monetary tightening.
- Current economic **data is noisy**, and one should not attach too much importance to short-term momentum. External factors such as lockdown/reopening dynamics make it difficult to attach predictive power to monthly or quarterly figures.

3. Banks' results and guidance point to high earnings growth

1. Q1 earnings

The Q1 earnings season has been excellent so far - in terms of revenue surprises, it is in fact one of the best quarters we have seen in a long time:

On aggregate, revenues were 7% higher than expected - the strongest positive surprise in years - while earnings were 25% better On a Y/Y basis, revenues and earnings grew respectively by 8.5% and 6% vs Q1 2021 (which was itself a strong quarter). Dynamic lending supported retail banking, while CIBs navigated market volatility much better than anticipated.

Loan losses remained very low (which is not surprising as unemployment, which is one of the best predictors of loan losses, is at historical lows and improving), though banks postponed their Covid provision releases due to the war in Ukraine.

Costs have been in-line (<1% higher than expected), with a similar number of banks coming above and below expectations, which is somewhat reassuring in light of inflationary pressures.

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Source Equity Index Name STOXX Europe 600 Bank... Range Current Season Periodicity Quarter
Banking Range CQ1 Ending: 2/16/2022 - 5/15/2022

Subgroup (BICS)					Sales			Earnings		
Ticker		Company	Report Date		Act	Est	Surpl	Act	Est	Surp
▸ Expected										
▾ Announced										
RBI	AV	RAIFFEISEN BANK INTERNATIONA	05/04/2022 (AM)		1.881B	1.457B	29.07%	1.220	0.576	111.91%
NDA	SS	NORDEA BANK ABP	04/28/2022 (AM)		2.490B	2.085B	19.45%	0.222	0.162	37.32%
GLE	FP	SOCIETE GENERALE SA	05/05/2022 (AM)		7.281B	6.307B	15.44%	0.872	0.330	164.33%
BARC	LN	BARCLAYS PLC	04/28/2022 (AM)		6.496B	5.732B	13.32%	0.084	0.032	167.16%
UCG	IM	UNICREDIT SPA	05/05/2022 (AM)		5.017B	4.428B	13.31%	0.113	0.203	-44.52%
BNP	FP	BNP PARIBAS	05/03/2022 (AM)		13.218B	11.683B	13.14%	1.710	1.018	67.98%
STAN	LN	STANDARD CHARTERED PLC	04/28/2022 (AM)		4.274B	3.853B	10.92%	0.348	0.250	39.20%
NWG	LN	NATWEST GROUP PLC	04/29/2022 (AM)		3.027B	2.741B	10.43%	0.086	0.055	55.31%
SEBA	SS	SKANDINAVISKA ENSKILDA BAN-A	04/27/2022 (AM)		14.768B	13.375B	10.41%	2.863	2.379	20.36%
BBVA	SM	BANCO BILBAO VIZCAYA ARGENTA	04/29/2022 (AM)		5.939B	5.399B	10.01%	0.240	0.205	17.07%
ISP	IM	INTESA SANPAOLO	05/06/2022 (AM)		5.414B	4.985B	8.61%	0.086		
BAMI	IM	BANCO BPM SPA	05/05/2022 (PM)		1.186B	1.109B	6.91%	0.117	0.085	38.00%
DNB	NO	DNB BANK ASA	04/28/2022 (AM)		15.141B	14.272B	6.09%	4.710	3.828	23.03%
SAB	SM	BANCO DE SABADELL SA	04/28/2022 (AM)		1.285B	1.224B	4.97%	0.038	0.028	37.71%
BKT	SM	BANKINTER SA	04/21/2022 (AM)		499.000M	477.333M	4.54%	0.171	0.133	28.48%
RILBA	DC	RINGKJOEBING LANDBOBANK A/S	04/27/2022 (AM)		674.000M	644.750M	4.54%	12.350	11.490	7.49%
DBK	GR	DEUTSCHE BANK AG-REGISTERED	04/27/2022 (AM)		7.328B	7.025B	4.32%	0.579	0.536	8.06%
ACA	FP	CREDIT AGRICOLE SA	05/05/2022 (AM)		5.938B	5.701B	4.16%	0.210	0.182	15.60%
SHBA	SS	SVENSKA HANDELSBANKEN-A SHS	04/27/2022 (AM)		12.305B	11.817B	4.13%	2.817	2.246	25.41%
PEO	PW	BANK PEKAO SA	04/28/2022 (AM)		2.824B	2.722B	3.73%	3.460		
EBS	AV	ERSTE GROUP BANK AG	04/29/2022 (AM)		2.036B	1.989B	2.40%	1.050	0.983	6.83%
LLOY	LN	LLOYDS BANKING GROUP PLC	04/27/2022 (AM)		4.206B	4.128B	1.89%	0.013	0.015	-10.74%
CABK	SM	CAIXABANK SA	04/29/2022 (AM)		2.775B	2.726B	1.82%	0.088	0.071	24.22%
SAN	SM	BANCO SANTANDER SA	04/26/2022 (AM)		12.305B	12.177B	1.05%	0.141	0.129	9.51%
INGA	NA	ING GROEP NV	05/06/2022 (AM)		4.600B	4.554B	1.01%	0.110	0.168	-34.44%
BG	AV	BAWAG GROUP AG	04/26/2022 (AM)		325.000M	321.800M	0.99%	1.240	1.163	6.59%
HSBA	LN	HSBC HOLDINGS PLC	04/26/2022 (AM)		12.549B	12.667B	-0.93%	0.162	0.147	10.30%
DANSK	DC	DANSKE BANK A/S	04/29/2022 (AM)		10.327B	10.464B	-1.31%	3.200	3.739	-14.42%
SWEDA	SS	SWEDBANK AB - A SHARES	04/28/2022 (AM)		11.455B	11.611B	-1.34%	4.100	4.051	1.22%

Source: Bloomberg

2. Guidance / EPS momentum

Forward curves have steepened significantly since the start of the year. This is particularly important in the Eurozone and has mostly been driven by long-term inflation expectations. As a result, banks are now back to being a growth sector, at least in the medium-term: revenues and earnings for the European banking sector are forecast to grow at respective annual rates of c. 4% and c. 13% in 2023 and 2024 (2022 is assumed to be unchanged vs. 2021 as analysts prudently predict a slowdown in fees and a rise in credit losses).
The Q1 earnings season will likely lead to FY EPS upgrades of about 3-4% on average for 2022 and 2023.

What is our view versus current analyst expectations?

- The most important driver of banks' earnings - i.e. interest rates - is currently being underpriced by analysts. Especially in the Eurozone, analysts are very prudent and a full one percentage point behind market pricing for ECB deposit rates at December 23. Given the high sector sensitivity to an increase in interest rates (between 25% and 35% depending on deposit beta for a 100bps shift on a 2021 base), it means that future earnings could be understated by double digit percentage points.

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Dec23 policy rates	Market implied	Bank analysts' assumptions
Eurozone	1,50%	0,50%
UK	2,60%	2,00%
US	3,25%	3,00%

- On the rest, we are more or less in line with consensus. We believe that credit losses could increase back to cycle average, possibly a bit higher than that. We assume a normalization in trading revenues. On costs, consensus might be a touch optimistic. We think that cost/income ratios will not fall much. Banks' administrative cost structures are roughly split as follows: 70% staff, 20% IT and 10% premises. The good thing is that salary growth has been contained in Europe so far - but the flip side to that is low salary growth does not reconcile with sustainable higher rates. In the short-term at least, it will be helpful for operating leverage.

Overall, should analysts align with current interest rate curves, EPS expectations can grow by about **15% for 2023** - currently low multiples appear even lower when adjusting for this.

4. Scenarios and price targets for the rest of the year

The current market debate centers around whether the ongoing supply crisis will morph into a demand crisis. We have argued that, should supply and monetary conditions end up not worse than what is currently priced in, growth should be just fine. It feels as if we are currently on a ridge line, with no definitive argument suggesting that we should end up falling on one side or the other:

- On the one hand, **should supply conditions ease** (more oil is pumped as extractive capacities are restored, Russian gas cut becomes unlikely, China shifts away from zero-Covid strategy, people return to work), we may enter on a very strong rally sustained by a combination of increased purchasing power and less need for a monetary tightening
- On the other hand, **should supply conditions worsen,** then current problems might compound and lead to a recessionary loop, especially if central banks are not supportive

Unfortunately, much rests on **totally unpredictable factors** (no one is in the head of Putin or Xi Jinping). The only moderate/high conviction call we have is that central banks are unlikely to push too hard in the face of worsening supply. In any case, investors should find comfort in the fact that banks are currently very cheap and offer an attractive asymmetric downside/upside profile.

Probability	Commodities/supply chains	Central banks*	2023 EPS shock	Multiple	SX7E price target
5%	Get worse	Get more hawkish	-21%	Bear	64
25%	Get worse	Soften stance	-33%	Average	82
20%	Stay the same	Get more hawkish	11%	Bear	90
20%	Stay the same	Soften stance	-11%	Average	109
20%	Improve	Get more hawkish	24%	Average	152
10%	Improve	Soften stance	3%	Bull	161

** We apply a 75 bps downward or upward interest rate shock depending on the scenario.*

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Antonio Roman

CFA, Qualified Actuary

Portfolio Manager of the Axiom European Banks Equity fund

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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