ALTERNATIVE INVESTMENTS

January 2024

Keep calm and keep your carry on

Subordinated Debt Outlook 2024

Banks' fundamentals are the strongest in a decade. CET1 ratios are almost at their all-time high, profitability is on the rise and return on equity is finally above cost of equity. Despite all this, investors still benefit from significant spread pick up on financial bonds, and especially AT1s. In this context, what should we expect for bank credit in 2024?

In this note, we discuss the following themes:

- **Fundamentals: should we be afraid of falling rates? Or are rising rates the threat?**
- **Regulations: are there any new regulatory discussions we should be aware of?**
- **We are in 2024 now, what is happening on Legacy bonds?**
- **Should we expect upgrades or downgrades?**
- **Valuations and relative value**
- **What are the possible curve balls?**

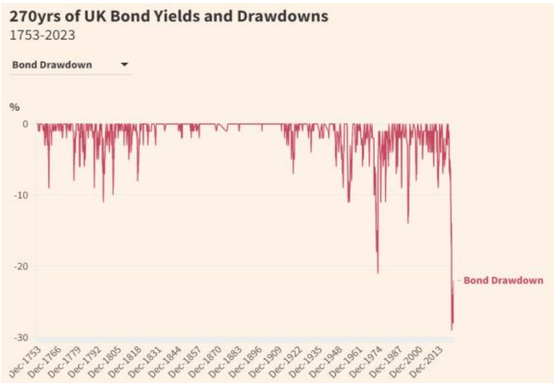
I. Fundamentals: it's all about rates?

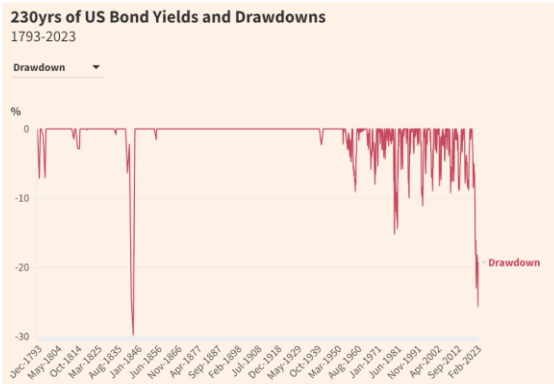
Banks can be confusing. Early in 2023, most investors had finally understood that higher rates meant higher profitability. So, high rates = good. The European banks index had rallied by close to 50% from the post Ukraine war lows.

But it swiftly reversed after a combination of extraordinary events in the US and Switzerland. The market suddenly realized that some US banks had massive unrealized and unhedged losses on their bond books and that some business models were not sustainable: Silicon Valley Bank, Signature Bank, First Republic, and Credit Suisse failed – a first for a GSIB. So, high rates = bad?

What about now? Should we be afraid of lower rates expectations and banks returning to the gloom of N/ZIRP sluggish profitability? Or would those lower rates be good for them because of improved asset quality and lower unrealized bond losses? Or are rates not even going to go down?

We think this Gordian knot is easy to cut. 2022/2023 was a quite unique period and this is what triggered the extraordinary performances of 2023 – both good (for highly IR sensitive banks like some Spanish names) and bad (for SVB and some others.) The FT managed to produce those two historical charts showing the savage drawdowns observed on government bonds in 2022/2023: the largest drawdown ever (well, since 1753) in the UK and the second largest in the US.





Source: Financial Times

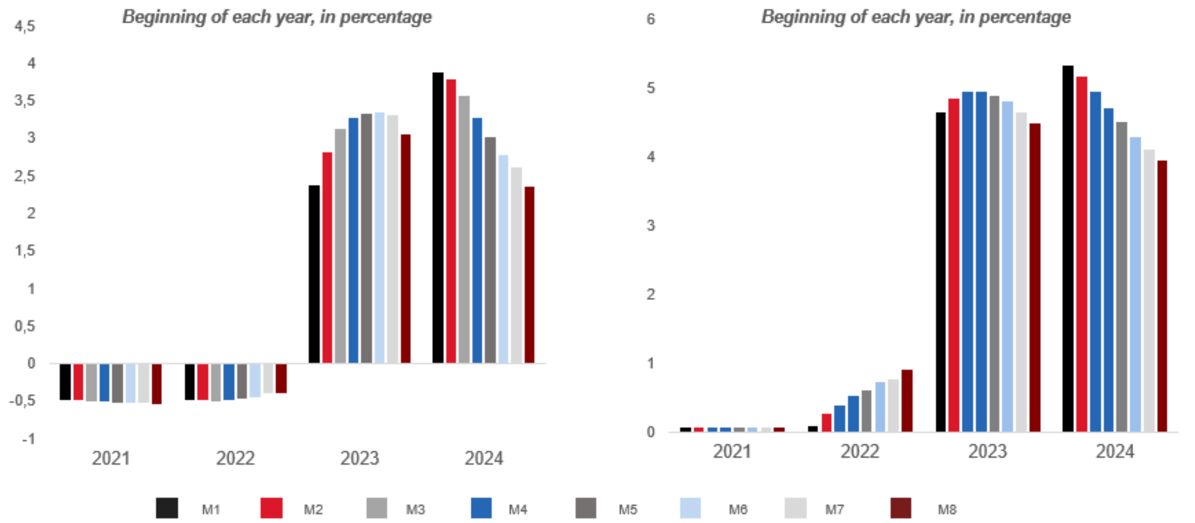
So, yes, higher rates are generally better for banks but the two things that are really bad (and that is what credit investors should care about) are negative rates, because they create severe threshold effects, and crazy moves that tend to break risk models and unprepared balance sheets.

Rates moves in 2024 are unlikely to produce the same dramatic effects, for several reasons.

a) Expected rates moves look nothing like 2022/2023

This is what ECB rates expectations looked like over the next 7 meetings at the start of 2021, 2022, 2023 and 2024. Yes, 2024 is now showing expectations of cuts but from a starting point higher than in 2023 and with a magnitude that is hardly significant compared to the move since 2021. For banks, the most important is that they don't go back to the N/ZIRP world.

EUR forecast of policy rates for the 7 next meetings | **USD forecast of policy rates for the 7 next meetings**

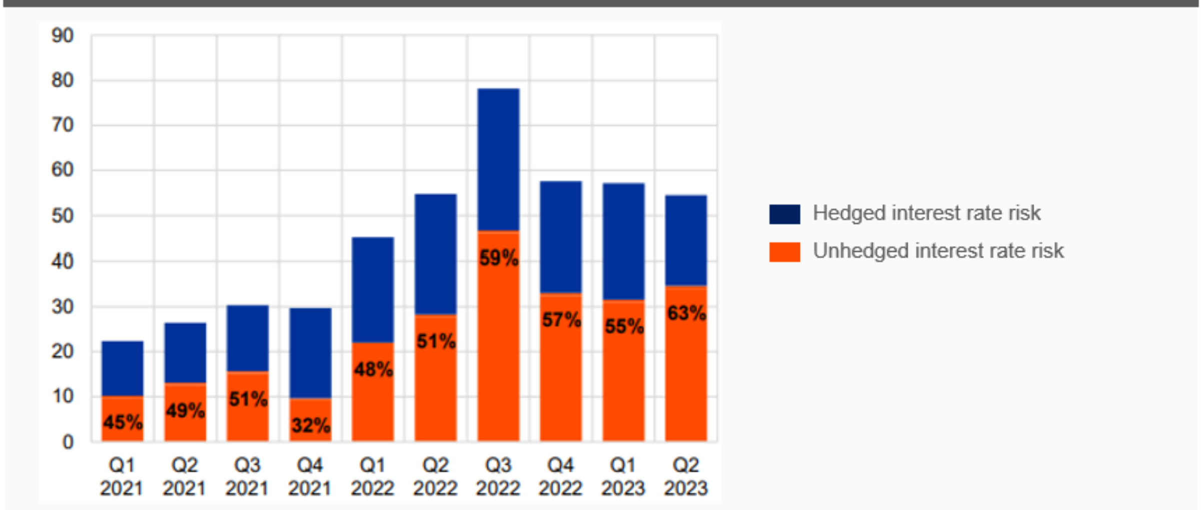


Source: Bloomberg

b) EU Banks are well hedged

Unlike US or, worse, Japanese banks, EU banks are well hedged against abrupt IR shocks. The EU has fully implemented the Interest Rate Risk in the Banking Book Basel standard and their equity exposure to a large IR increase is well below 10% of equity, with a significant fraction being hedged.

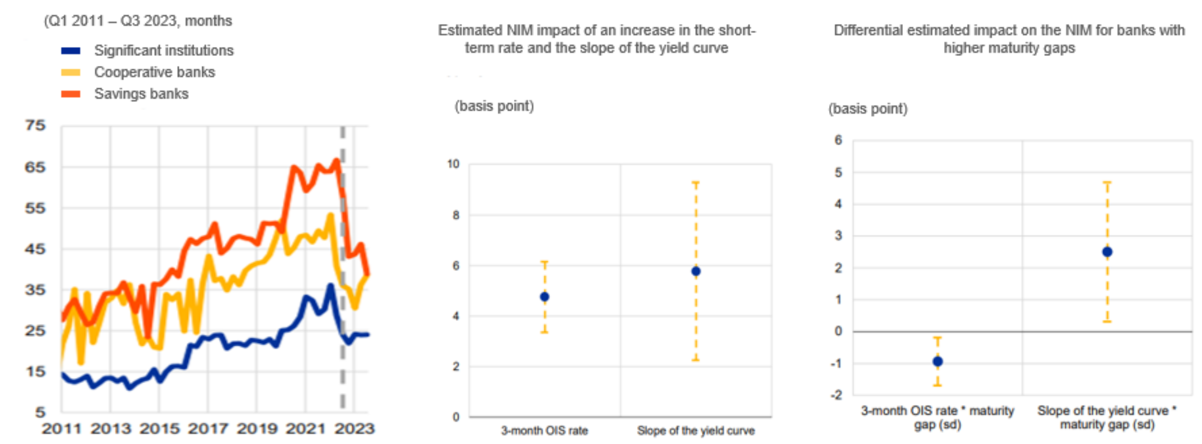
Euro Banks hedged and unhedged interest rate risk *(Q1 2021 – Q2 2023, in € billions)*



Source: ECB

On the flip side, their NII sensitivity to a -25bps parallel shift in curves is below 2% - hardly a credit relevant move. The charts below show that the asset/liability maturity gap has narrowed which also means that their sensitivity to higher curve slopes has gone down.

Duration mismatch is going down	So, banks are still NIM sensitive	But sensitivity to slope is also down



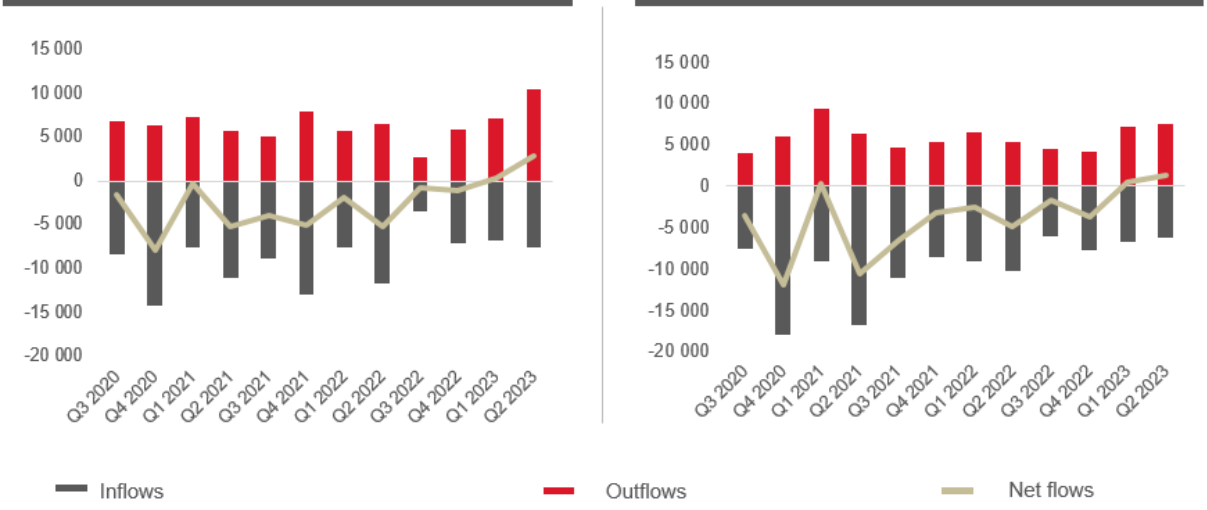
Source: ECB

c) Asset quality could benefit from lower rates

One main area of concern for bank investors has been asset quality. This is probably why bank stocks have been consistently trading with a discount to the general market, despite spectacular upwards earnings revision.

Their most troubled clients would benefit from lower rates, in particular Commercial Real Estate companies, where NPL have been picking up since Q3 2022, or consumer lending, where NPLs inflows have remained muted despite a small increase in 2023.

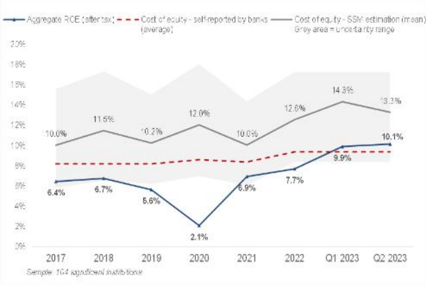
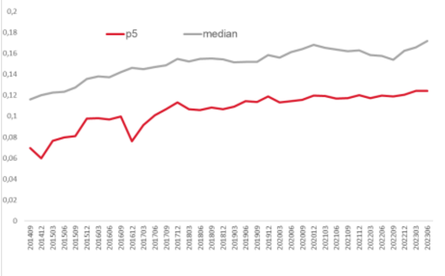
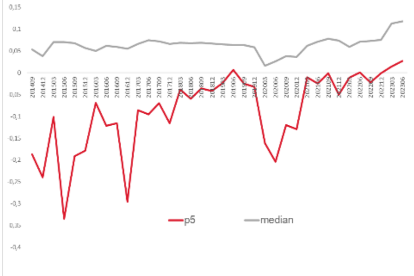
CRE NPL flows (in EUR M)	Consumers Loans NPL flows (in EUR M)



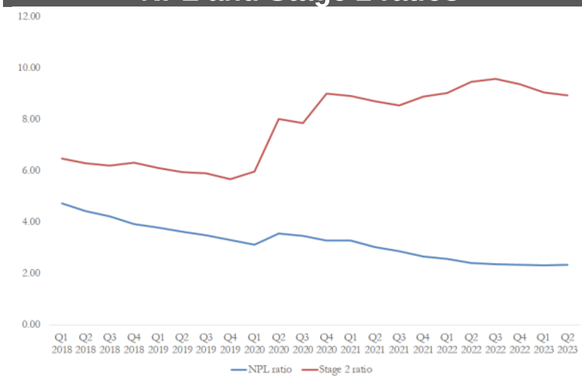
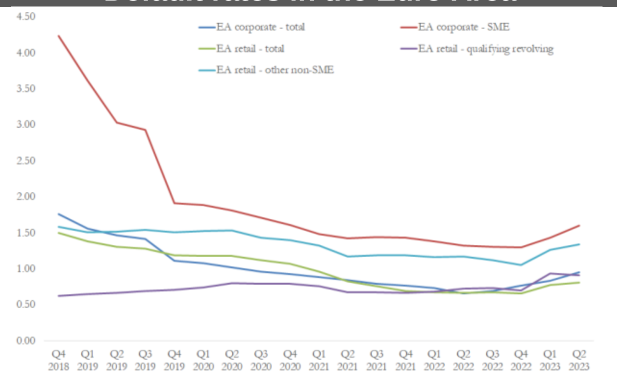
Source: ECB

d) Risk metrics are improving

Two of the most important risk metrics (CET1 ratios and profitability) have shown steady improvements over the past decade and there is no reason to expect that this would sharply reverse due to mild IR moves. It is also worth pointing out that not only have the average metrics improved, but the outliers, i.e., banks in the worst 5-percentile, have improved even more, reducing the dispersion and “zombie risk”, in our view.

ROE finally above COE after ten years	Median and 5-percentile CET1 ratios improving steadily	Median and 5-percentile ROE: sector higher, fewer very negative outliers
		
Source: SSM	*Source: EBA*	*Source: EBA*

Troubled loans metrics are also not showing any sign of stress despite a small increase in default rates after they were suppressed by the massive public support granted during the Covid crisis.

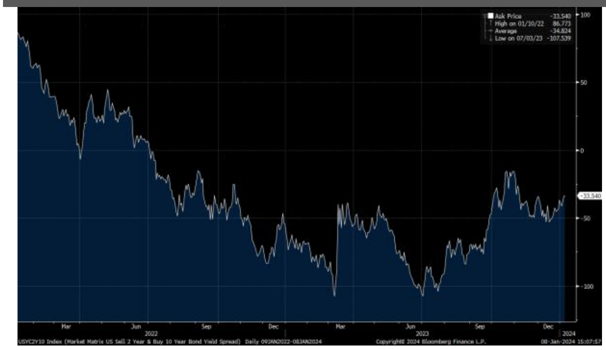
NPL and Stage 2 ratios	Default rates in the Euro Area
	
Source: ECB	*Source: ECB*

Does this mean we should feel safe investing in bank credit ahead of a possibly recessionary environment?

Firstly, this recession has been telegraphed for almost 18 months now and, despite some isolated negative quarterly prints (e.g. in Germany), it seems that the US and EU economies have been strong enough to avoid a full-fledged recession and might keep being so. A supposedly very reliable indicator, the slope of the US yield curve, has been consistently in negative territory since July 2022, but US GDP growth has remained stubbornly positive.

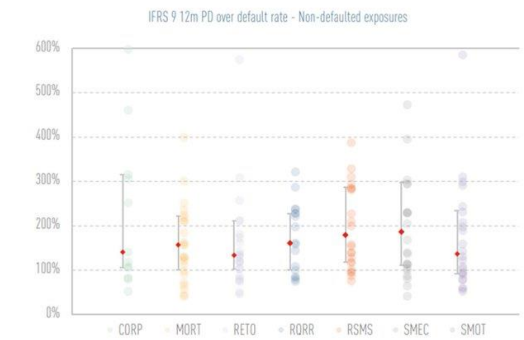
Secondly, and more importantly, we think pre-provision profit has reached levels high enough to absorb loan losses comparable to the Covid stress or even, for most banks, the peak stress of the past 15 years, without seeing any reduction of their CET1 ratios. Moreover, European banks still have a significant amount of discretionary overlays on top of their provisioning models. Those provisions were mostly established during the Covid stress, recycled into Ukraine / energy crisis provisions and are still left unused, despite the fact that EBA data shows that 1-year default rates estimated for provisioning models are on average 50% above real-world defaults rates.

US treasury curve slope: 2y-10y



Source: Bloomberg

Banks are conservative! Model probabilities of default are above real-world probabilities of default

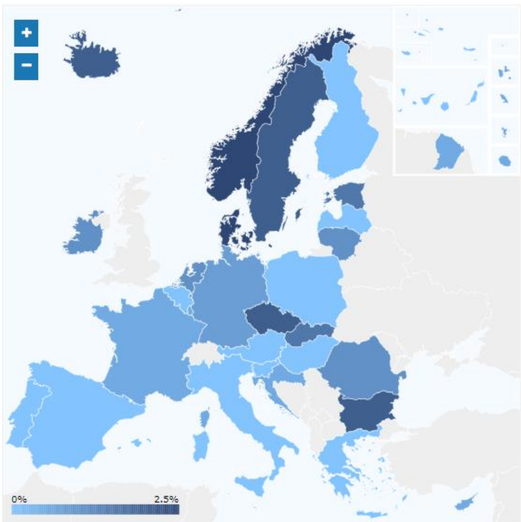


Source: EBA

II. Regulations: the big sleep?

After years of watershed changes in banking regulations, it is finally time for stabilization. If banks' capital requirements are still going up (and protecting creditors even more) it is mostly due to the phasing-in of old regulations, in particular the gradual implementation of countercyclical buffers in the EU – still an ongoing process as the map below shows. After years of debates and negotiations, the most significant piece of bank regulations, Basel 4, has now turned into an irrelevant tweak to banks' capital requirements, mostly because banks have already adapted to the new rules.

Countercyclical buffers still have room to increase…



Source: ESRB

<u>*But Basel 4 is now largely irrelevant.*</u>

Bank group	CET1	Tier 1			Total capital	
		Risk-based	Stand-alone LR-based	Risk-based and LR-based Tier 1	Risk-based	Risk-based total capital and LR-based Tier 1
All banks	0.0	0.0	0.4	0.4	0.3	0.7
Group 1	0.0	0.0	0.4	0.4	0.0	0.4
Of which: G-SIIs	0.0	0.0	0.4	0.4	0.0	0.4
Group 2	0.0	0.0	0.0	0.0	0.3	0.3

Table 3: Change in total T1 MRC, as a percentage of the overall current Tier 1 MRC, due to the full implementation of Basel III (2033) under the EU specific scenario (weighted averages, in %)

Bank group	Credit risk				Market risk	CVA	Op Risk	Output floor	Other Pillar 1	Total risk-based	Revised LR	Total
	SA	IRB	Securitisation	CCPs								
All banks	1.5	0.2	0.0	0.0	1.8	0.4	1.7	6.8	-0.6	11.8	-1.1	10.7
Group 1	1.2	0.1	0.0	0.0	2.0	0.4	2.0	7.8	-0.7	12.8	-0.8	12.0
Of which: G-SIIs	1.7	1.2	0.0	0.0	3.5	0.8	2.4	7.7	-0.2	17.1	2.9	20.0
Group 2	3.0	0.9	0.0	0.0	0.5	0.3	0.3	1.9	0.0	7.0	-2.6	4.3

Source: EBA

Are there still important developments to monitor? Of course. Bank regulators never sleep. We highlight three important items.

a) *What's going on with Cocos?*

Unsurprisingly, the wipeout of Credit Suisse's AT1 triggered of flurry of more or less hazardous takes about the future of the asset class and "necessary" changes to the legal format. Some of those suggestions were not really new (e.g., the trigger level, the introduction of stoppers, etc.), some were more innovative (limitations on calls, for example), but the asset class recovered quickly, and those discussions faded away. From our discussions with national and international stakeholders, we understand that the appetite for such changes is actually very limited. Despite the dubious choices of the Swiss authorities, the cynic in every regulator has to admit that AT1s did what they were supposed to do, absorb losses, so what would be the point in new lengthy and technical discussions at the Basel level?

There is however one key aspect which needs to be monitored. In October 2023, the Financial Stability Board dropped this little bombshell in its "*Credit Suisse – lessons learnt*" report.

> According to the SEC staff, there would have been legal challenges relating to US securities laws in executing a bail-in; they noted that banks need to prepare sufficiently to comply with US securities laws after an open bank bail-in. US investors held bail-in bonds issued by Credit Suisse representing a significant portion of the firm's TLAC. US securities laws apply to any TLAC instruments held by US investors, irrespective of the currency or governing law of that TLAC instrument.

It had been known for a while that the enforcement of cross-border resolutions is extremely complex – as highlighted by the Banco Popular / TotalBank case in the US - and this led to the introduction of new language requirements on AT1 prospectuses and the possible disqualification of some bonds. But the point made by the FSB – and earlier by the SEC – is different. It appears that resolution actions that would convert bonds into equity are hardly compatible with US securities law, which applies pretty much to any security, as long as it has been sold to US investors. Naturally, this would also apply *mutatis mutandis* to CoCos, i.e. AT1 bonds with conversion clauses, something which was clearly not anticipated and should lead to further highly technical legal discussions and maybe required changes to contract language – with the corresponding legacy status for old bonds.

b) How stable is stable?

Another possible regulatory change driven by Credit Suisse is the recalibration of the Liquidity Coverage Ratio. Much has been said about the swift evaporation of CS's liquidity and the fact that its apparently very high LCR (200%) did not offer much protection. As a reminder, this ratio compares 30-day cash inflows to 30-day (stress) cash outflows to assess if a bank is available to weather a liquidity storm. The LCR was never intended as a measure of robustness, but rather as a tool to check that a bank can survive the few days or weeks necessary to implement a rescue plan. In that respect, again, the LCR did its job: Swiss authorities had the time they needed to "rescue" Credit Suisse.

Still, the LCR must be calibrated: in practice, weights are attributed to balance sheet items to estimate the likely 30-day outflow and it is important to assess whether such weights are realistic or conservative. In the case of CS, the culprit appears to be the non-stable deposits (see Basel definition below) which are weighed by a 10% factor, meaning that it is assumed that 10% of those deposits can vanish in a month.

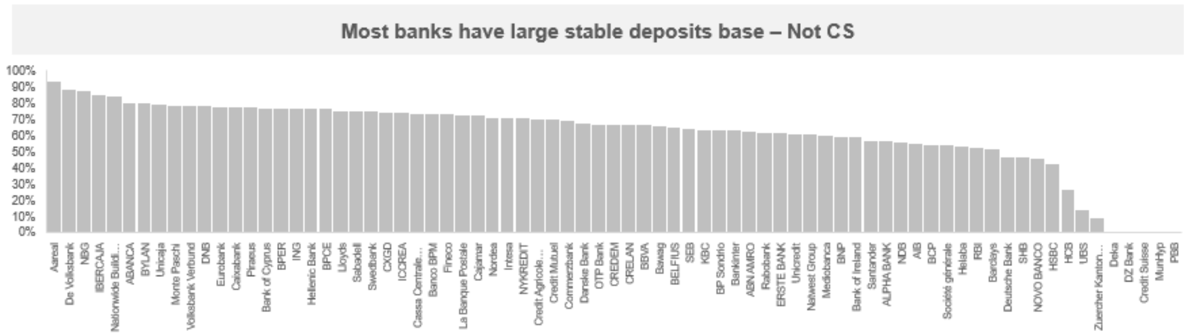
The LCR calculations treat stable and non-stable deposits differently

Stable deposits, which usually receive a run-off factor of 5%, are the amount of the deposits that are fully insured by an effective deposit insurance scheme or by a public guarantee that provides equivalent protection and where:

- the depositors have other established relationships with the bank that make deposit withdrawal highly unlikely; or
- the deposits are in transactional accounts (e.g. accounts where salaries are automatically deposited).

Less stable deposits (run-off rates = 10% and higher)

Source: BIS

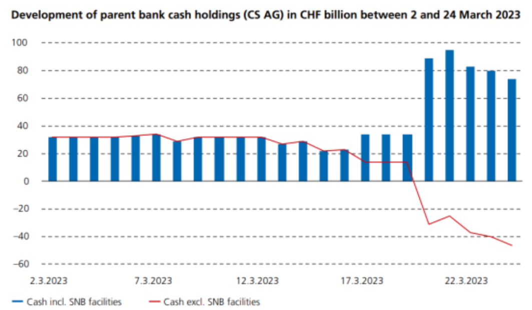


Market data | Source: BIS, FINMA, Axiom AI, Company reports

CS was very specific in that respect as they had exactly – and astonishingly – 0% of stable deposits, which made them highly sensitive to the wrong calibration of such outflows.

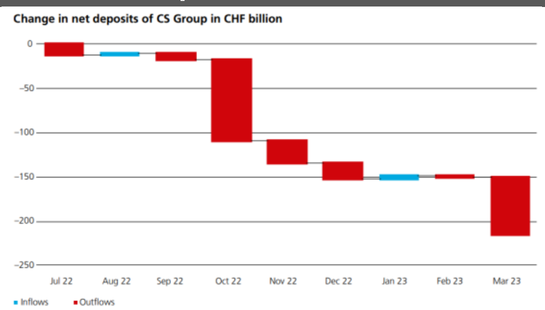
At Q2 2022, CS had 153bn$ of deposits and the chart below, taken from FINMA's report, shows that both in October 22 and in March 23, outflows far exceeded the 10% monthly regulatory ratio. For some specific clients, the number were staggering: 51% of all term deposits were withdrawn in Q4 2022 and 81% of all deposits in the investment bank (source: FINMA).

Cash trend at CS



Source: FINMA

Deposit flows at CS



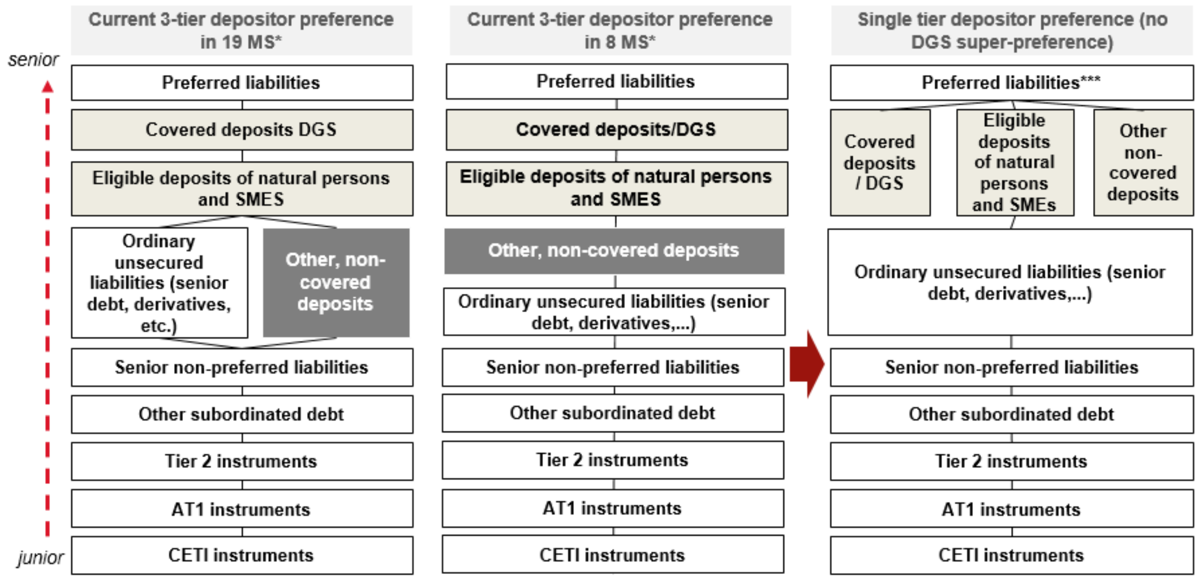
Source: FINMA

The recalibration of the LCR is likely to be high on the agenda of regulators and this could contribute to further stabilize the sector, at the expense of lower profitability (HQLA are expensive and negative carry assets).

c) Depositors' preference

Setting aside the CS drama, the most important regulatory chart published in 2023 could be this one, from the European Commission.

General depositor preference in the ranking of claims in national insolvency laws, with a single-tier ranking that removes the super-preference of DGS claims (Article 108(1) BRRD)



Source: European Commission | *AT, BE, CZ, DE, DK, EE, ES, FI, FR, IE, LV, LT, LU, MT, NL, PL, RO, SE and SK | **Other 8 MS have preferred non-covered deposits relative to ordinary unsecured claims (BG, CY, EL, HR, HU, IT, PT and SI). | ***The Single Resolution Fund National resolution funds are among preferred liabilities | Note: this illustration is stylised and simplified. The hierarchies of claims across Member States are only partially harmonised (especially subordinated layers), while the senior layers are largely unharmonized and may include additional sub-classes.

This relates to one of the most convoluted and intricate topics in banking regulations. It deals with the hierarchy of claims in bankruptcy and how this impacts the hierarchy in resolution and the compatibility with the three key principles of crisis management: financial stability, No Creditor Worse-Off and legal certainty. As the chart above demonstrates, EU countries have taken different route when implementing the TLAC Term-Sheet principles, that require supervisors to be able to bail-in senior debt and keep deposits unharmed without triggering significant legal challenges linked to their *pari-passu* position under most bankruptcy regimes[1]. Hence, the existence of holding company debt in some countries, senior non preferred bonds in others or changes to bankruptcy law in a third group of countries.

The aim of the European Commission – harmonization and consistency – is certainly a noble one, but from an investor's point of view, there is almost something comical at the idea that the seniority of a "senior bond" might end up changing twice in less than a decade… Because BRRD was introduced before the finalization of the TLAC Term Sheet, a complete revamp was required (BRRD2) and this led to the introduction of a new asset class, so-called MREL bonds, most notably senior non preferred bonds. For some banks, or some bank subsidiaries, this means that they have to come to capital markets for the first time in their life and to issue expensive senior debt, sometimes combining new issue, new issuer and new product premium! Many smaller banks, especially in CEE, have been complaining about the costs of this new asset class and supervisors or regulators have been worried about their capacity to issue such debt. In practice, for investors like us, it means we have been able, and will be able, to buy debt at what we think are very attractive risk return profiles.

[1] *As often when discussing this topic, this is a simplified description of the legal situation. Do not hesitate to reach out should you want more details.*

However, once the new framework is implemented, it is likely that a large part of the newly created market will become useless, simply because regular senior debt will achieve the same regulatory goals: it will be senior debt that can be bailed-in and that is junior to deposits! Banks could be tempted to buy back those MREL bonds, at a premium for bondholder, to save costs… A very attractive prospect for investors.

It goes beyond the scope of this note but should also be stressed that what is true in the EU, is not necessarily true in the US. The latest American proposal for implementing Basel 4 has huge ramifications that could even impact the balance of competition on both side of the pond. For our deep thoughts on this project, please read https://www.ft.com/content/eb0c389e-3b25-457f-ae3f-994827fb32f6.

III. Legacy bonds – stuck in the past

When Basel 3 introduced the grandfathering period of bank capital and implicitly created the Legacy market, a deadline was set at the end of 2021. We are now in 2024 and that market still offers interesting opportunities. How come?

- New rules created new Legacy bonds. CRR2 and BRRD2 introduced new criteria for bank capital and MREL, which led to a flurry of new bonds categorized as legacy bonds.

- Solvency 2 introduced a cutoff date for Legacy bonds in 2026.

- The combination of BRRD, CRR and SRB policy, as well as the EBA's opinion on infection risk, has created a complex web of rules that drive the economic and regulatory rationale of keeping (or not) old Legacy bonds as pure funding or MREL instruments. Some banks have tried to keep very cheap bonds in their balance sheet (sometimes in sharp contrast with our opinion about the said bonds), but 2023 has shown that, more often than not, those banks have no choice but to call the bonds. Recent examples include DNB, which called Disco bonds after a very aggressive market communication pointing to the opposite decision, or BNP, which was arm-twisted by the EBA and had to change it long held policy of not calling some bonds and including them in regulatory capital.[2]

- The phasing out of Libor and so-called "hard Legacy instruments" has also been a key driver of redemptions. Banks are often not able to introduce substitute benchmarks and end up with no choice but to call the bonds or face onerous litigation. US Synthetic Libor, which is still allowed on a temporary basis, will be totally phased out in 2024 so this will force the remaining issuers to reach a decision and to clean up their liabilities stacks.

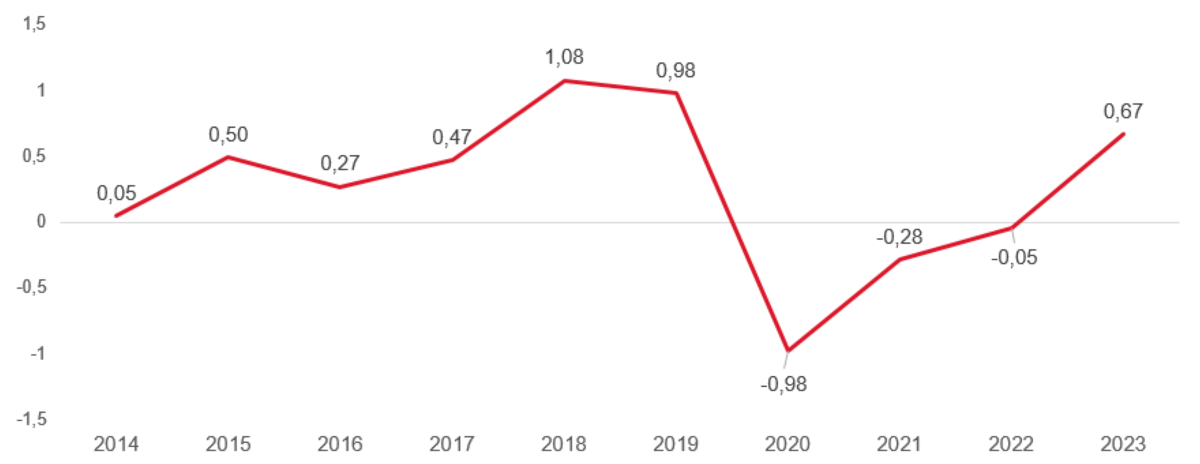
[2] *https://www.eba.europa.eu/sites/default/files/2024-01/0eb1efab-45be-4c5a-ac5c-118df304898c/2024%2001%2005%20Letter%20to%20Quinn%20Emanuel%20Urquhart%20%26%20Sullivan%20UK%20LLP%20on%20BNPP.pdf*

This note does not discuss specific bonds or funds, but, as an indication, the average price of Legacy bonds with floating coupons in our dedicated fund is around 82.6% of par with a 3.7% coupon (nil coupons are a thing of the past, now), which suggests that the potential upside is intact[3].

IV. Ratings: a one-way street?

Since the Covid shock, it looks like credit agencies have moved overwhelmingly in the good direction for financials. The chart below shows the average, for the three main agencies, of the logarithm of the upgrade / downgrade ratio every year[4]. The trend of the post crisis reform was clearly interrupted by Covid but has now resumed.

Logarithm of the average upgrade / downgrade ratios of the three main agencies on European Financials



Data as at 14/01/2023 | Source: Axiom AI, Bloomberg | We use the logarithm for two reasons: firstly, it is not meaningfully possible to calculate the average of direct upgrade/downgrade ratios and secondly using direct ratios is misleading: take the example when upgrades are twice more frequent than downgrades, the ratio is 2, and when the reverse is true, the ratio is 0.5, but the average of the two is 1.25, which wrongly suggests that upgrades are more frequent and that somehow a ratio of 2x is more significant than a ratio of 0.5 – when they are equivalent. The absolute number of upgrades and downgrades cannot be used because the three agencies do not rate the same number of companies.

Credit ratings tend to move slowly, so this suggest that 2024 should be another positive year for rating trends. Moreover, within the European financial fixed income universe, there are significantly more positive outlooks than negative outlooks (the ratio is almost 3:1 currently.)

It should also be stressed that the above chart underestimates the quality of the rating trends of European financials. Indeed, looking at the individual rating actions, it appears that the downgrades include many European subsidiaries of Chinese banks or downgrades that were triggered by methodological changes (e.g. UniCredit's Tier 2 rating at Moody's) or spillover from downgrades (e.g. the four downgrades of Julius Baer entities count as four actions instead

3 The average spread is 798bps but this is obviously highly dependent on redemption assumptions and, as such, is a less straightforward metric than the average price.

4 We use the logarithm for two reasons: firstly, it is not meaningfully possible to calculate the average of direct upgrade/downgrade ratios and secondly using direct ratios is misleading: take the example when upgrades are twice more frequent than downgrades, the ratio is 2, and when the reverse is true, the ratio is 0.5, but the average of the two is 1.25, which wrongly suggests that upgrades are more frequent and that somehow a ratio of 2x is more significant than a ratio of 0.5 – when they are equivalent. The absolute number of upgrades and downgrades cannot be used because the three agencies do not rate the same number of companies.

of one.) Taking the example of Moody's, the only "economic" downgrades (including mere outlook revisions) at group level appear to be Julius Baer, Swiss Re, Vontobel, M&G, EFG, Direct Line Insurance, IKB, SHB, Aegon, UBS and SCOR and obviously Credit Suisse.

On the contrary, upgrades were more broad-based, with many companies in the periphery benefiting from sovereign improvement or successful implementation of restructuring plans (Ibercaja, Caixa Central de Credito Agricola Mutuo, Novo Banco, Montepio, Caixa Geral de Depositos, BCP, Banco BPM, Intesa, Sabadell, Monte dei Paschi, Bank of Cyprus, Hellenic Bank, Bank of Cyprus, Alpha Bank, Piraeus Bank, Arion…) but also improved operational profiles in the core (ABN AMRO, Crelan, SpareBank, Coface, DNB, Allianz, NIBC, NIBC, Principality Building Society, etc.)

Looking forward to 2024, it is hard to identify clear candidates for a downgrade, whereas we see upgrade potential in many situations – such as Sabadell which has a positive outlook from the three agencies, Monte dei Paschi, which could soon return to private ownership after some very important court case wins, Novo Banco which has almost achieved its operational turnaround, *etc*.

V. Valuations: right in the middle

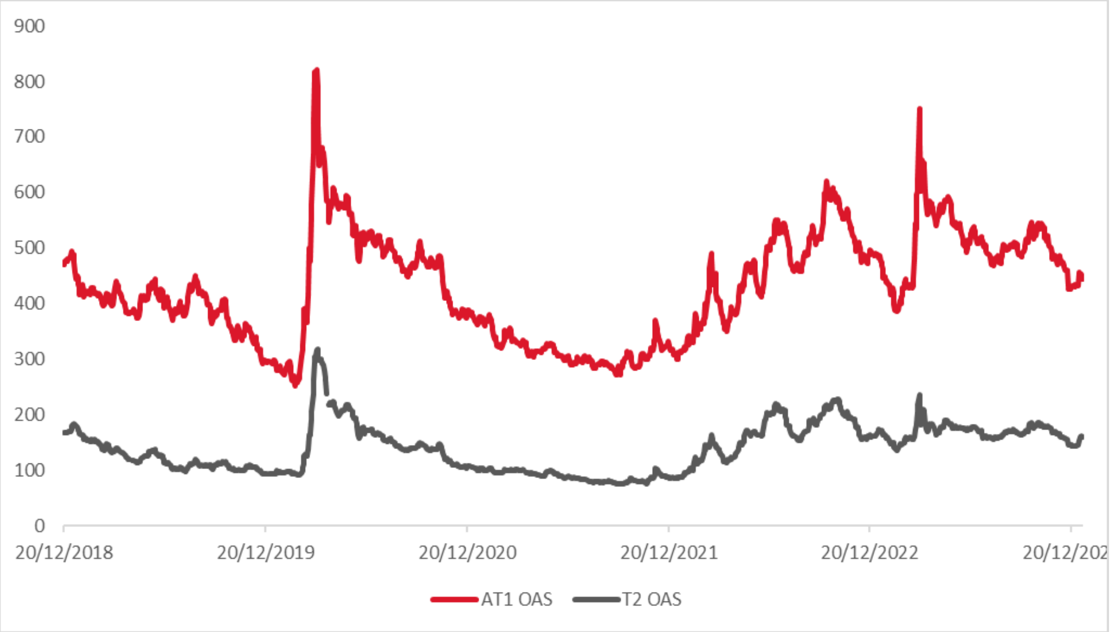
Despite a very tumultuous year, spread have (modestly) tightened in 2023 for all financials asset classes, except insurance RT1 bonds.

2023 changes in spread										
	Investment Grade								High Yield	
Z-Spreads to Govt.	€ Pref Snr	€TLAC Senior	£ TLAC Senior	€ Inco Snr	€ Bank T2	£ Bank T2	$ Bank T2	€ Inco Sub	AT1	RT1
Last (29Dec23)	138	165	152	122	225	236	173	256	528	597
Start (lJan23)	156	201	220	165	282	302	221	311	639	568
Delta	-18	-36	-68	-43	-57	-66	-48	-45	-111	+29
Tights	135	162	152	121	224	236	173	255	476	489
Wides	208	270	269	179	397	394	261	377	1100	853
% in Range	5%	3%	0%	2%	1%	0%	0%	1%	8%	29%
Total Return	6.1%	7.9%	9.1%	8.2%	8.5%	10.4%	8.9%	10.4%	8.1%	8.8%
Duration (years)	3.3	4.0	3.7	4.6	3.2	4.4	5.8	4.7	2.9	4.5
Yield	3.4%	3.6%	5.1%	3.2%	4.3%	6.0%	5.8%	4.5%	8.5%	9.1%

Source: Citi

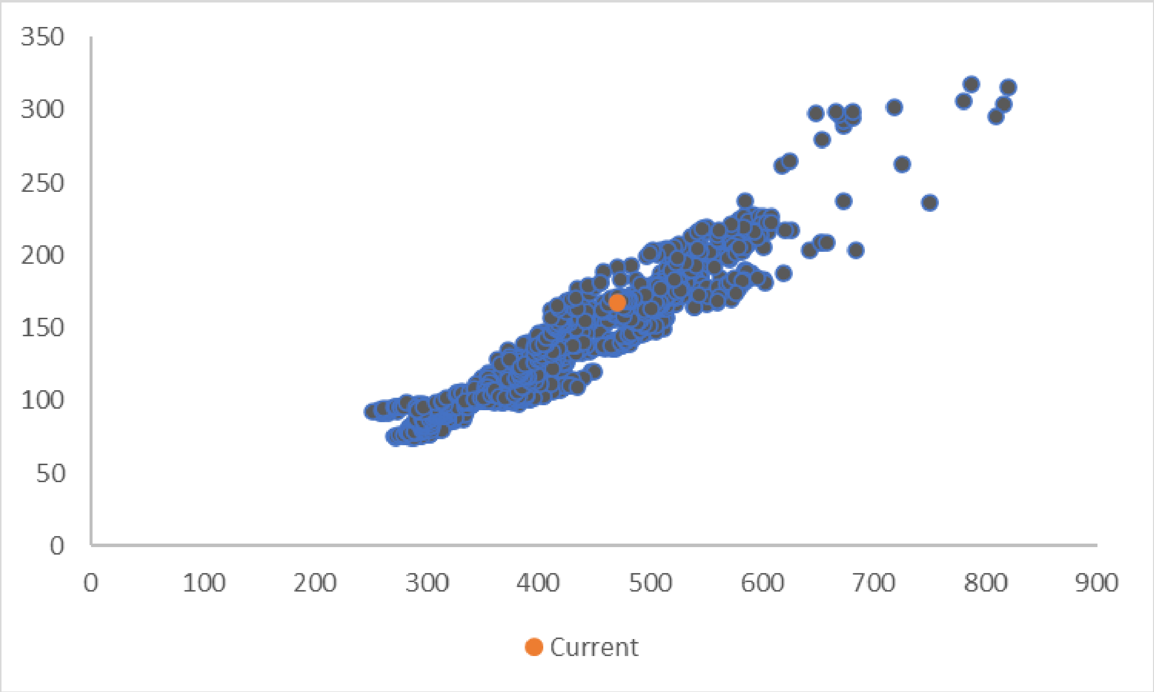
A longer-term view suggests both Tier 2 and AT1 spreads are not far from average historical levels. A scatter plot comparing Tier 2 and AT1 spreads is also not very compelling: current absolute and relative valuations are almost bang in the middle of past historical data.

AT1 and Tier 2 OAS Spread



Source: Bloomberg

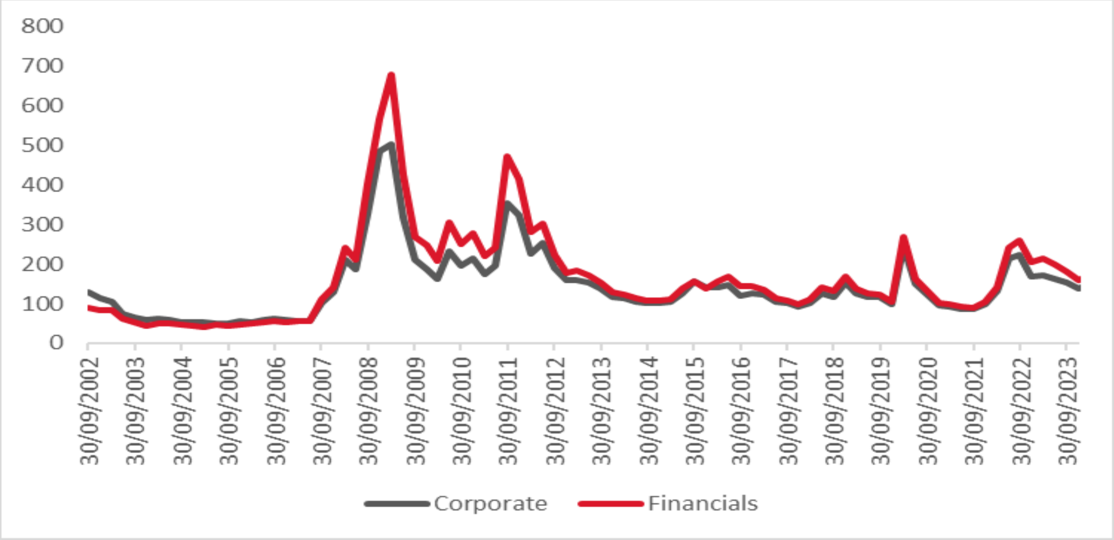
AT1 and Tier 2 OAS Spread scatter plot



Source: Bloomberg

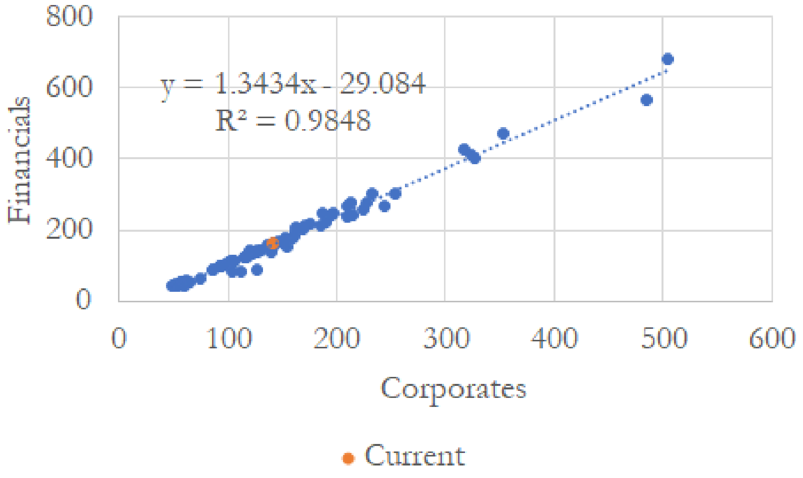
Including corporates in the relative value discussion does not provide much more insight. Before 2008, spreads on corporate issuers were consistently above spreads on financials. This relationship has reversed in a very consistent way. There is currently a 20-ish bps pickup on the spread of financials vs corporates in the Bloomberg Pan European Aggregate (IG) indices, but as we show below, there is nothing special about this spread difference. It is very much in line with past values. As we think the chart below also demonstrates, there is little value in trying to disentangle corporate and financial spread forecasts (at the aggregate, IG level) as the two times series exhibit remarkably high correlation.

Long term performance of Index OAS to Treasuries



Source: Bloomberg

Scatter plot - Index OAS to Treasuries, Corporates vs Financials



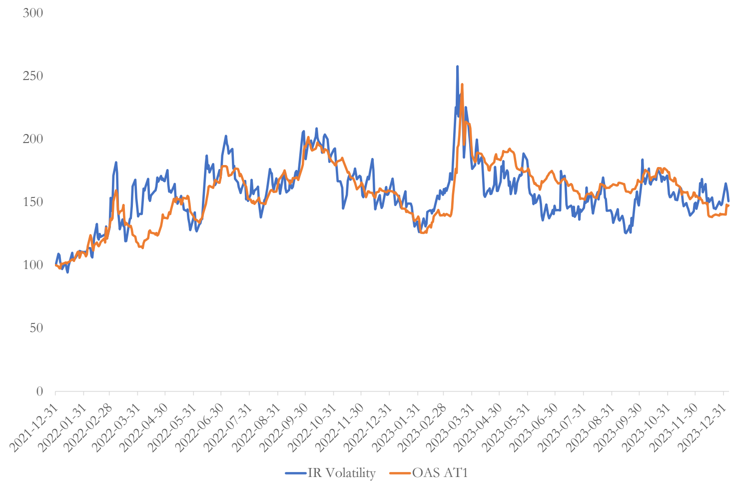
Source: Bloomberg

Apart from the fundamental outlook we discussed above, are there reasons to be structurally optimistic or pessimistic about spreads in 2024?

a) A normalized rates outlook could help

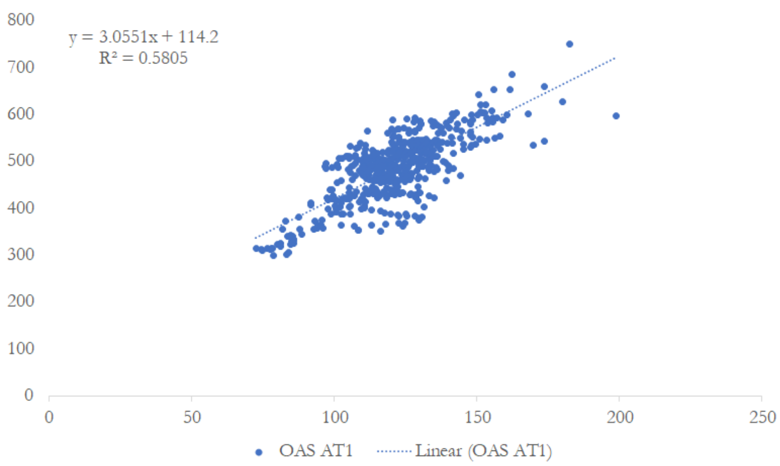
Rates were the main story of 2023, both in terms of fundamentals and in terms of market action (the banking crisis started with the disclosure of unrealized losses on bond holdings due to higher rates). It is therefore perhaps unsurprising that AT1 spreads were highly correlated to the MOVE index, which tracks implied volatility on short-term interest rates options, i.e. option traders' views about the uncertainty on future short-term rates.

IR volatility vs AT1 OAS - normalized



Source: Bloomberg, normalized as of 31/12/2021

IR volatility vs AT1 OAS – scatter plot



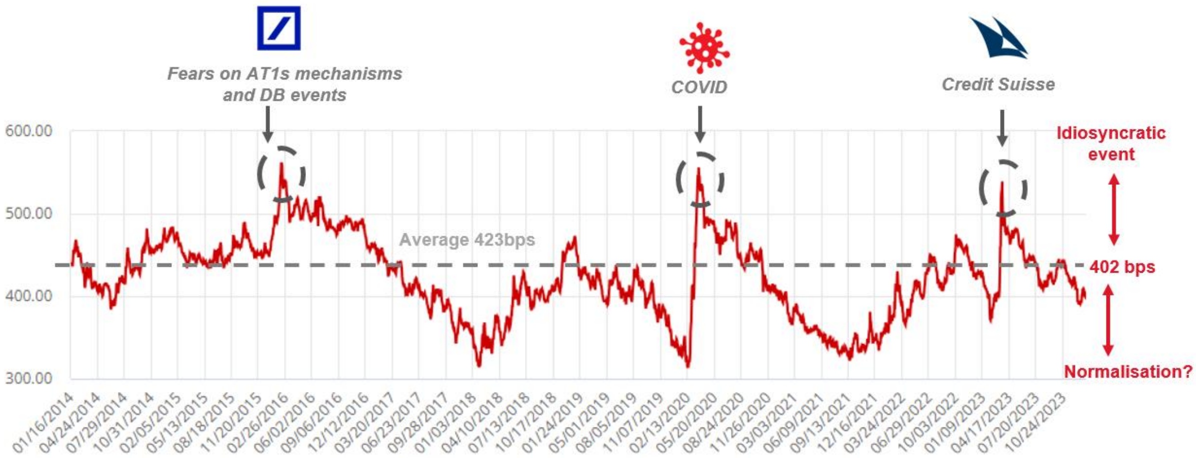
Source: Bloomberg

As discussed in the first section, central banks are expected to clarify their steady-state outlook after inflation has been normalized and this could contribute to lower IR volatilities and hence tighter AT1 spreads.

b) AT1 spreads react to idiosyncratic events

Over the past decade, AT1 spreads have tended to behave in a similar way: an idiosyncratic shock pushes spreads at extremely wide levels, then spreads revert to the mean, overshoot significantly this mean reversion, until a new shock comes. We do not see any specific reason to expect such a shock again this year – but let's be honest those shocks are by definition very hard to forecast – so investors should be aware that any further spread compression, although very possible on the back of improved fundamentals, could be quickly reversed should another shock come – macro or micro.

Evolution of the BofA CoCo index' spread over 10 years



Source: Axiom AI, ICE BofA

c) No drama expected from upcoming calls

After Santander became the first large bank not to call an AT1 at its first call date, the market has grown up and call decisions are not considered big market events anymore. However, they can still provide a decent amount of alpha when the bank's decision wrongfoots the market. Should we expect anything spectacular on that front in 2024?

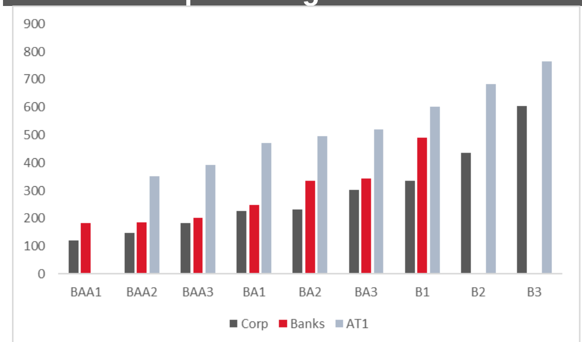
Q1 2024 should be rather quiet: four banks have already exercised their options to call, including Portuguese bank BCP on a bond that was trading at a 35% yield to call until May last year (yes, those absurdly high YTC on AT1 bonds are sometimes genuine). Moreover, we do not see any particularly controversial or highly uncertain call decision until Q2, with Van Lanschot and Volksbank Wien being probably the two upcoming calls that should attract the most interesting debate. Meanwhile, we think AT1 investors can safely ignore any discussion about calls – they will come up later.

AT1s from European banks: Call dates in 2024															
ISIN	Issuer	Ccy	Mn	Next Call date	Coupon	Next Calls	Outcome	ISIN	Issuer	Ccy	Mn	Next Call date	Coupon	Next Calls	Outcome
USF22797RT78	ACAFP	USD	1750	23/01/2024	7,875%	5 years	Called	XS1984319316	BAMIM	EUR	77	18/06/2024	8,750%	5 years	n/a
PTBCPFOM0043	BCPPL	EUR	400	31/01/2024	9,250%	Quarterly	Called	XS1592884123	SANUK	GBP	500	24/06/2024	6,750%	5 years	n/a
USH4209UAT37	UBS	USD	2500	31/01/2024	7,000%	Semi-annual	Called	US539439AG42	LLOYDS	USD	1675	27/06/2024	7,500%	5 years	n/a
XS1951093894	SANTAN	USD	1200	08/02/2024	7,500%	Quarterly	Called	XS1679216801	BAERVX	USD	300	12/06/2024	4,750%	Semi-annual	n/a
XS1952091202	SHBASS	USD	500	01/03/2024	6,250%	5 years	n/a	XS1658012023	BACR	GBP	1250	15/09/2024	5,875%	5 years	n/a
BE0002638196	KBCBB	EUR	500	05/03/2024	4,750%	Semi-annual	n/a	US404280AS86	HSBC	USD	2250	17/09/2024	6,375%	5 years	n/a
US05565AHN63	BNP	USD	1500	25/03/2024	6,625%	5 years	n/a	XS2046625765	SWEDA	USD	500	17/09/2024	5,625%	5 years	n/a
XS1586367945	DANBNK	USD	750	28/03/2024	6,125%	Semi-annual	n/a	XS1961836712	COVBS	GBP	415	18/09/2024	6,875%	5 years	n/a
ES08132211010	BBVASM	EUR	1000	29/03/2024	6,000%	Anytime	n/a	USF2R125CF03	ACAFP	USD	1250	23/09/2024	6,875%	5 years	n/a
XS1892756682	LANSNA	EUR	100	01/01/2024	6,750%	Semi-Annual	n/a	US65557CAN39	NDASS	USD	500	23/09/2024	6.125%	Semi-annual	n/a
AR000B121991	VOWIBA	EUR	200	09/04/2024	7,750%	5 years	n/a	XS2056697951	AIB	EUR	500	09/10/2024	5,250%	Semi-annual	n/a
XS1597324950	ERSTBK	EUR	169	15/04/2024	6,500%	Semi-annual	n/a	XS1691468026	NIBCAP	EUR	200	15/10/2024	6,000%	Semi-annual	n/a
XS1956051145	INTNED	USD	1250	16/04/2024	6,750%	5 years	n/a	FR0013457702	MMGFRA	EUR	100	30/10/2024	8,000%	n/a	n/a
XS1614415542	ISPIM	EUR	247	16/05/2024	6,250%	Semi-annual	n/a	XS2075280995	DNBNO	USD	850	12/11/2024	4,875%	Annual	n/a
XS2003473829	LPTY	EUR	500	29/05/2024	7,375%	5 years	n/a	XS2080995405	LLOYDS	GBP	500	27/11/2024	5,125%	n/a	n/a
XS1046224884	UCGIM	USD	1250	03/06/2024	8,000%	Semi-annual	n/a	XS2029623191	FINBAN	EUR	300	03/12/2024	5,875%	Semi-annual	n/a
XS1959441640	VMUKLN	GBP	250	08/06/2024	9,250%	5 years	n/a	XS1692045864	INVPLN	GBP	250	05/12/2024	6,750%	Quarterly	n/a
ES0840609004	CABKSM	EUR	1000	13/06/2024	6,750%	Quarterly	n/a	XS2048709427	NWIDE	GBP	600	20/12/2024	5,875%	5 years	n/a
US06738EBG98	BACR	USD	2000	15/06/2024	8,000%	5 years	n/a								

d) *Enjoy the carry*

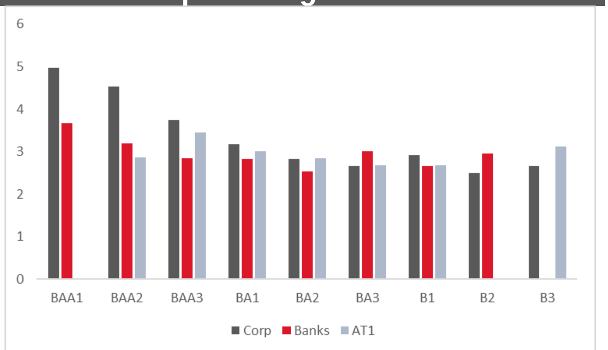
It should hopefully be clear from the above that we do not have a very strong view on the general outlook on credit spreads for 2024 – both in absolute terms and on a relative value basis. In such circumstances, we believe a key goal should be to preserve performance with higher carry. Using granular index data, we can extract the current spread and credit durations of corporate issuers, bank issuers (ex-AT1) and AT1 bonds: for a given rating, the pick-up on bank spreads is significant, especially on AT1 bonds, despite durations that are on average slightly lower.

Spreads on corporates, banks and AT1 per rating bucket



Source: Bloomberg, Axiom. We believe the B2 bucket for banks is not significant as it mostly contains a restructured bond. We show OAS (Option Adjusted Spreads). Data as of 8-jan-2024

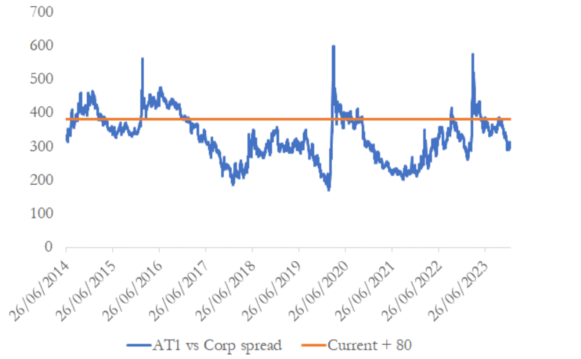
Durations on corporates, banks and AT1 per rating bucket



Source: Bloomberg, Axiom. We show OAD (Option Adjusted Durations). Data as of 8-jan-2024.

This allows us to calculate the break-even widening: how much do relative spreads on financials need to widen vs. corporate spreads to offset the higher carry that financials offer? We estimate that the AT1 breakeven relative widening is approximately 80bps. On a historical basis, this relative value widening is not unseen, but it is only consistent with episode of severe crisis (Covid, CS, Q1 2016.)

Break-even widening per rating	Historical performance of AT1 vs. corporate spread compared to breakeven widening



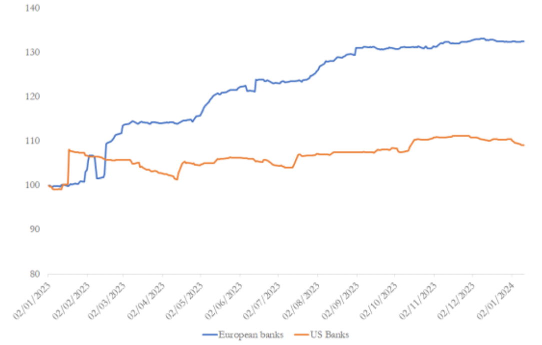
Source: Bloomberg, Axiom AI. The breakeven widening is defined as the difference in spread divided by the OAD of (respectively) banks or AT1 bonds. Data as of 8-jan-2024

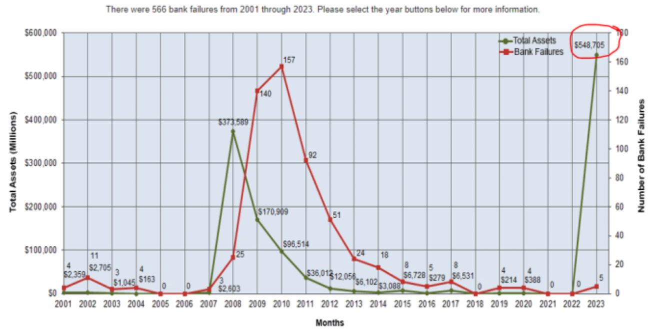
Source: Bloomberg, Axiom AI

VI. Where are the risks

2023 saw unprecedented upgrades in European bank's earnings prospects and significant upgrades in the US, and yet we had the first failure of a GSIB and five failures in the US, with the first FDIC interventions since 2020 and the highest annual total assets of failed banks. This clearly shows that problems can happen in a positive environment.

EPS estimates in 2023	Bank failures in the US





Source: Bloomberg, normalised at 100 on Jan 1st 2023

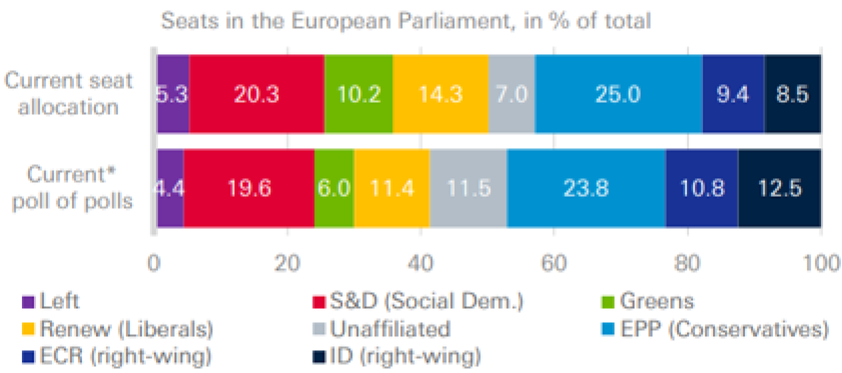
Source: FDIC

What are the possible sources of instability in 2024?

a) (Geo) political risks

There is no doubt that the (geo)political environment is uncertain. On top of the large geopolitical risks (Ukraine, Middle East, Taiwan) the world is facing major elections in 2024: US presidential elections, European parliamentary elections, India general elections, etc., and populist parties are on the rise in several G7 countries (Germany, France, Italy.) Markets are however well prepared for another Trump mandate (markets reacted well to the first one) and odds of his win have been high for some time now. In Europe, despite a rise in populist rightwing parties, polls of polls suggest that a centrist coalition remains the most likely scenario – and possibly a second Von der Leyen commission, with no significant change to the political agenda.

European elections: forecast from polls of polls



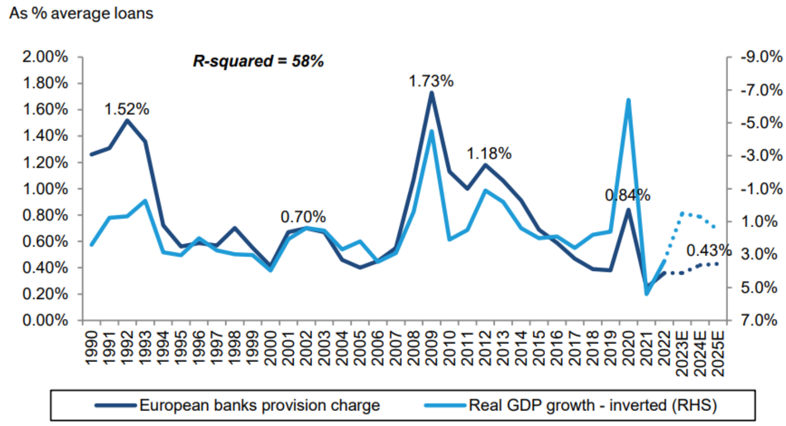
Odds of republican win at the next US elections

Market data | Source: Bloomberg, FDIC

b) Macro and asset quality

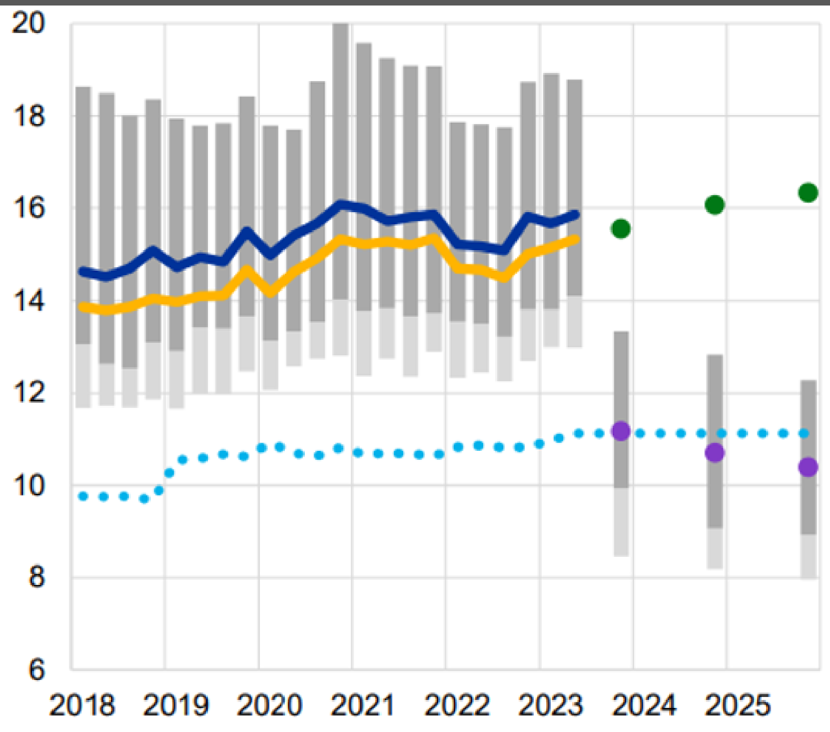
Banks are, and always have been, partly a macro play. If the market is wrong about soft landing or mild recessions in the US and the EA, what is the breaking point for banks? Historically, GDP and loan losses have had a strong correlation. There are currently only a handful of large banks where the ratio of pre-provision profits to cost of risk is below 3 – which means that the sector could in theory handle a tripling of loan losses without hurting capital ratios. Looking at the chart below, this suggests GDP growth would have to dip into deeply negative territory (-3%+). This has happened before, of course, but is very far off from current economists' forecasts. Even under the recent very conservative EBA/SSM stress tests, banks remained above 10% CET1r.

Provisions and GDP are correlated



Source: Autonomous

Despite requirements going up and stress scenarios ever more conservative, banks remain above 10% CET1r



Source: SSM. Green dots are baseline stress test scenarios, purple dots are severe stress. Blue dotted line is MDA requirement. Yellow and blue lines are average and median CET1r and grey bars show 10-25 and 25-75 percentiles.

We also take comfort from three considerations here:

- The above correlation was observed under old accounting rules, obviously. The switch to IFRS 9 and the introduction of Stage 2 loans means that banks have preemptively taken provisions ahead of a deterioration of some credits.
- As detailed in a very useful recent EBA report[5], banks still have a very significant amount of "overlays", i.e. precautionary provisions that go beyond what models calculate. They were initially introduced for Covid, then rolled over for Ukraine and now just remain in the balance sheets waiting for a possible use.
- Under IFRS 9, banks now provide a sensitivity analysis, which allows us to assess the impact of severe macro scenarios on their P&L. This increased transparency makes navigating bad outcomes much easier.

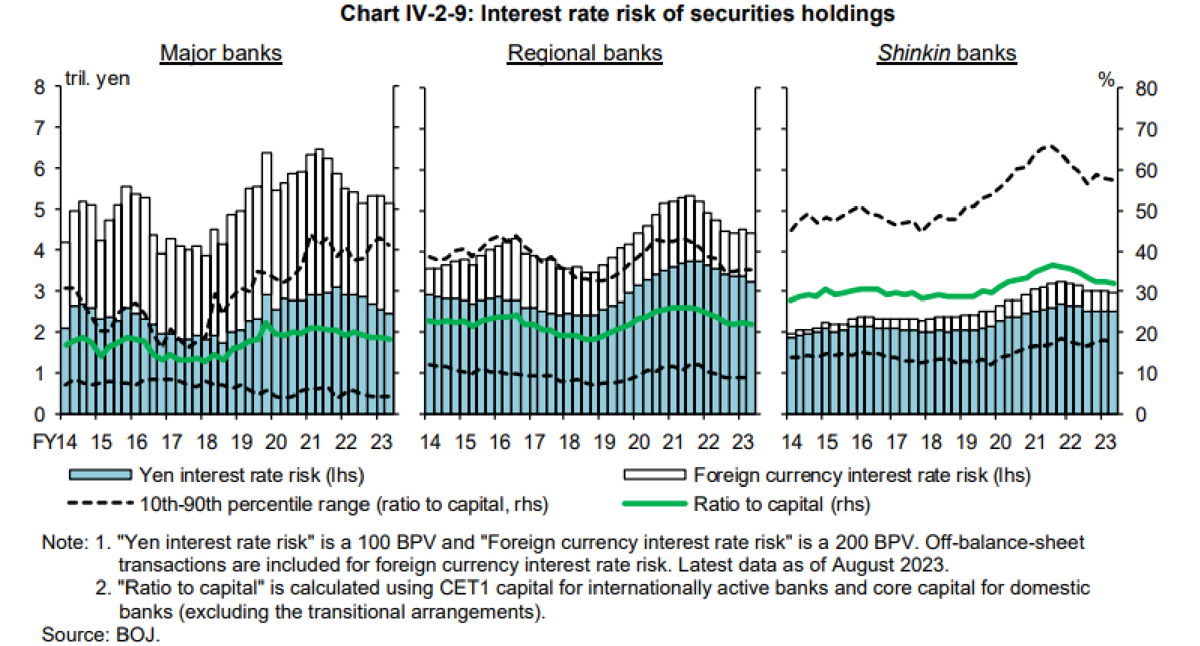
Overall, we think it is more important to be very careful about the few banks that have outsized exposures to distressed sectors than to worry about a global meltdown driven by a severe macro scenario.

c) Japanese banks

When some US banks blew up in March 2023 because of unrealized bond losses, we were very worried about Japanese banks. These have – by far - the largest interest rate risk in developed countries, which incidentally explains why the BOJ has been painstakingly slow in reversing the course of its monetary policy. Unlike SVB and the likes, these banks also have extremely sticky deposits which provide a buffer against IR risk and explain why they weathered the storm with no damage. Considering the size of the Japanese financial sector and the large risks in the less-well known but very large regional banks and Shinkin sectors, we still think this risk is significant.

[5] *https://www.eba.europa.eu/sites/default/files/document_library/Publications/Reports/2023/1063709/Final%20Report%20on%20IFRS9%20implementation%20by%20EU%20institutions.pdf*

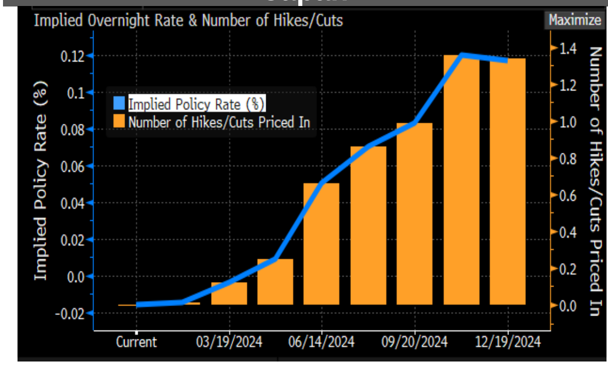
IRRBB risk of Japanese "banks"



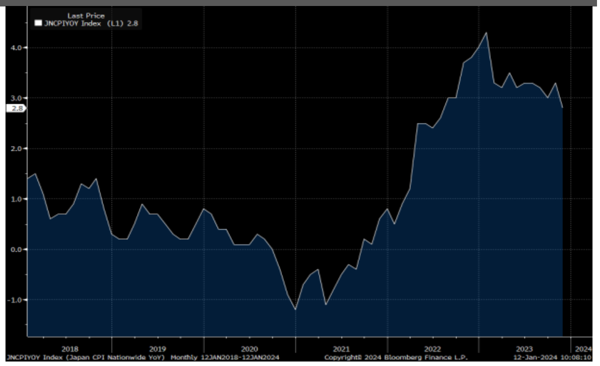
IRRBB risk is the economic risk to capital due to a rapid shift of the interest rates curve. Banks have to consider various scenarios (rates up or down, change in slope, etc.) Japan uses a milder scenario than other large economies: a +100bps parallel shift vs. +200bps in the US or the EA. Despite this less conservative assumption, the average risk for Shinkin banks is above 30% of equity and some institutions are above 60%. The situation is only slightly better at regional banks.

Extreme caution about its financial sector could very well be the reason why the market only expects one hike from the BOJ in 2024, despite inflation running at 3% for some time now.

Market-expectations of policy rates in Japan	**Japan CPI Nationwide YoY**



Source: Bloomberg



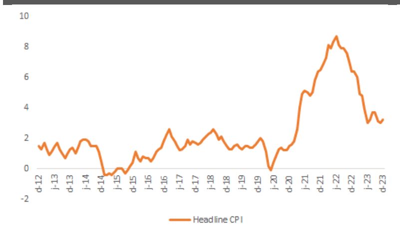
Source: Bloomberg

d) *Inflation: once more, with feeling?*

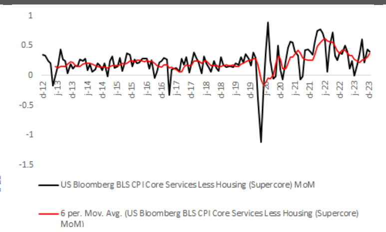
There is no shortage of analysis on the recent inflationary episode and its origins (supply chain disruptions, excessive stimulus, bullwhip effects after Covid, monetary policy, *etc.*) Current price trends point to a markedly lower inflation, but at a very slow pace – as John

Authers put it, “*slower for longer*”. Headline CPI is not going down anymore, supercore is sticky and the outlook for shelter is uncertain (it is often argued that the shelter CPI components lag the real world and that declines observed on indicators such as the Zillow rent index will feed into CPI soon, but, as shown below, we think this lag is far from obvious).

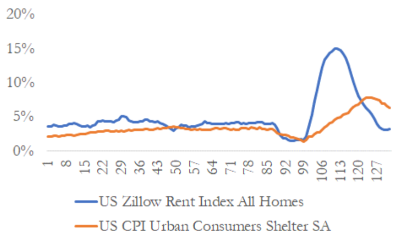
Headline is not going down anymore	Supercore is sticky now	Zillow going down more than CPI shelter – but is there a lag?



Source: Bloomberg



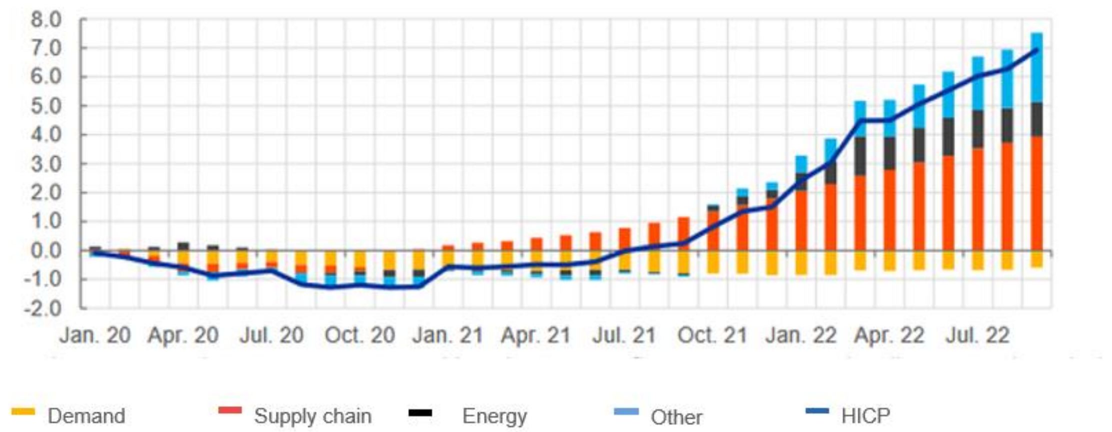
Source: Bloomberg



Source: Bloomberg

Still, central banks - and markets even more – sound utterly convinced that the war on inflation will soon be over and are ready to embark into rates cuts. STIR markets are pricing circa 140bps of cuts in 2024 for the US, EA and UK in order to achieve a goal that is not entirely clear to us: short-term and long-term inflations are still above their targets and there is no recession in sight. The point of a risk analysis is to imagine what could wrong with this scenario, so it is useful to go back at what triggered the inflation crisis. We are not entirely sure that this chart is reliable and accurate, but here is what the ECB believes triggered inflation.

Historical decomposition of shocks
(in percent; deviation from trend, contributions are cumulated from December 2019)

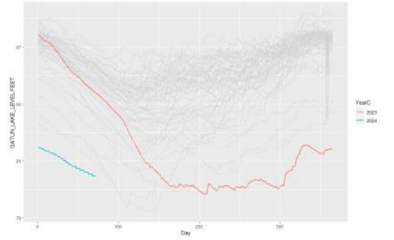


Source: ECB

If this is correct, and a supply chain shock was the culprit – maybe it could happen again? The combination of climate change and geopolitical risks could weigh on global trade, as illustrated by the current difficulties faced by the largest shipping choke points. In Panama, climate change has led to the lowest levels recorded for Lake Gatun. The authority had to reduce traffic. In the Red Sea, Houthis attacks have forced shipping companies to use alternative routes, hence the spike in traffic through the Cape of Good Hope, which is much longer and more expensive. Overall, the number of ships going through the global chokes points is markedly going down.

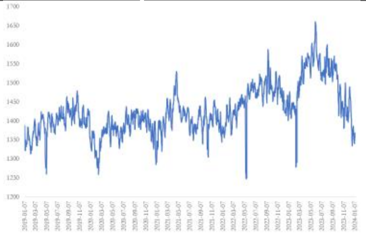
If the market is wrong, this could be the source of unexpected spikes in inflation.

Depth of Lake Gatun



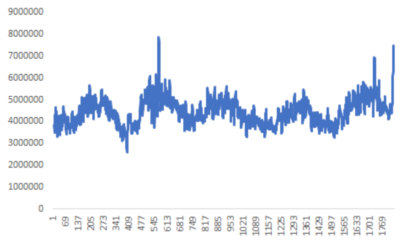
Source: Panama Canal Authority. In grey we show 60 years of daily data. 2024 includes forecasts from the authority.

Total number of ships through shipping choke points



Source: IMF. The IMF identifies 13 global chokepoints and provides traffic data using satellite imagery.

Total capacity going through the Cape of Good Hope



Source: IMF

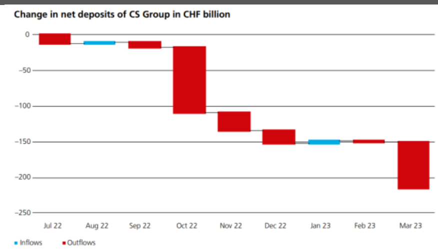
a) <u>The weakest link</u>

We might have too quickly forgotten that Credit Suisse's doomsday spiral started with a tweet from an Australian journalist. This triggered wider CDS spreads, a deposit flight, a capital increase, and ultimately the poorly phrased reply from the Saudi National Bank chairman about further financial support.

The "on the brink" tweet

Source: X

What else happened in October 2022?



Source: Swiss authorities

What lessons we got from this?

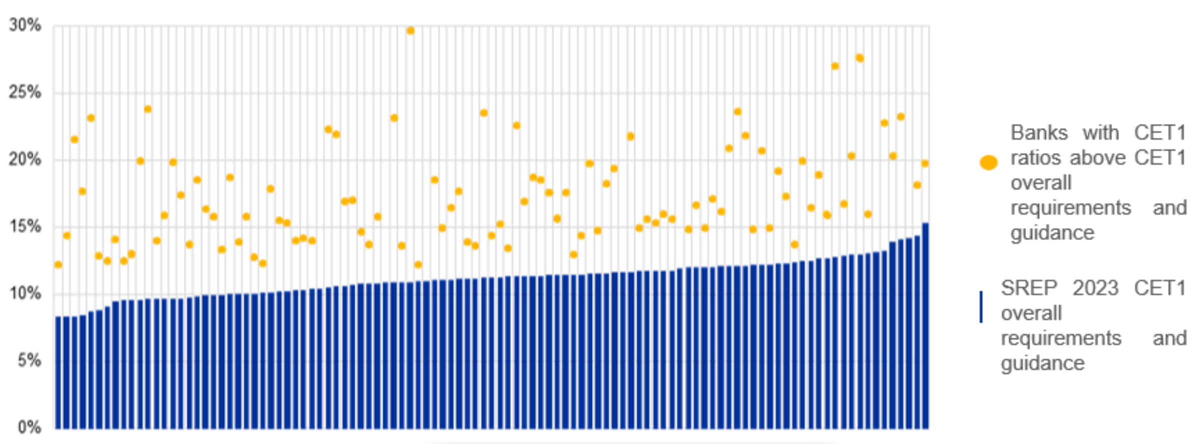
- We should not underestimate the power of fake news on social media. Yes, it was fake news, because the journalist admitted that his tweet was based on conversations with an analyst who had no inside knowledge of the situation.
- Self-fulfilling prophecies do happen, but they take time and there is not automaticity – We cannot count the number of idiotic tweets saying that Deutsche Bank is "*on the brink*" or some equivalent statement.
- Perhaps more importantly, the "weakest link syndrome" is still an important feature. The infamous tweet did not mention any name and yet, for almost everyone, it was clear that Credit Suisse was the only possible target. This is because Credit Suisse had accumulated scandals, trading mishaps, governance failures, etc., like almost no

one before. Back in October 2022, very few analysts believed Credit Suisse was in actual danger of failure, but if you had made a poll to nominate the weakest GSIB, Credit Suisse would have won easily.

Do we still have "weakest links" in European banking? If a credible journalist tweeted "*I'm told that an [Italian/UK/Spanish/French/GSIB/German, etc.] bank is on the brink*" who would come to mind, and would it matter?

After 15 years of restructuring of the sector and some failures, it is increasingly difficult to answer this question. The SSM has been publishing this chart for several years now, and for the first time, there is not a single bank for which the yellow dot is below the blue bar (despite the very weird legend chosen by the SSM).

Capital requirements, including undisclosed Pillar 2 Guidance, vs. actual CET1 ratio



Source: SSM

Obviously, high capital ratios are not a guarantee of financial health, but the opposite is true: low capital ratios are a guarantee of financial problems! So, this chart is important, and it marks another milestone in the long post-2008 journey of European banks.

Looking more specifically at our hypothetical tweet, what could we say?

- The weakest GSIB is now **probably** Deutsche Bank. But this is a bank that has weathered countless social media storms, that has restructured itself deeply, that has a retail bank that has finally become a cash machine thanks to higher rates, that had been upgraded by Moody's three times, by S&P and Fitch two times, all since 2021…
- In the UK, Metro Bank and Cooperative Bank would have been the obvious choices only a year ago, but the first one has finally undergone the restructuring that we think was required (including a haircut on subordinated debt) and the second is reaping the benefits of its painful transformation and is likely to be purchased by one the strongest bank credit in the UK, Coventry Building Society…
- In Italy – and we cannot believe we are writing this – it looks like even Monte dei Paschi is out of the woods! Higher rates have had a tremendous effect on profitability, obviously, but court decisions were also key. After several Supreme Court wins, we

think the litigation outlook - and related provisions or contingent liabilities - is now much clearer and much less worrying. We do see a path for privatization and a return to normality.

- In Germany, setting aside Deutsche Bank, the risk is clearly concentrated on some banks with outsized CRE exposures. They are, however, relatively small banks, with strong expertise in the field (and not CDO tourists like West LB in the 2000s) which means that a) we think they should be volatile, but fine, and b) any unexpected failure would be contained.
- In France, bank tourists would probably jump on La Banque Postale, on the back of its abysmal stress-test results, but anyone with decent knowledge of that bank would laugh and we really struggle to identify a meaningful French bank with “weakest link” risk.
- Despite higher rates, there are still some banks with weak credit profiles in the periphery, but they all look better than a year ago and are small enough not to matter globally.

Jérôme Legras

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Jérôme worked for 12 years at Société Générale as Deputy Head of the Structured Capital Finance activity. He previously worked at CCF (then HSBC France) as a financial engineer in the Research and Innovation Department, mainly on quantitative risk measurement and derivatives valuation. He joined Axiom Alternative Investments in January 2013.

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