AXIOM
ALTERNATIVE INVESTMENTS

20th of November, 2023

European Banks 2023-2024: defying market sentiment with unparalleled yields and fundamentals

In an environment of sticky inflation, recessionary fears and more recently geopolitical tensions, investors have turned away from risky assets to money market funds and other "recession-proof assets". Additionally, we have seen outflows of £5.5bn in UK Funds in October highlighting very well the current investor mood.
True, 3% to 5% almost risk-free yields offered by government bonds may indeed seem appealing in this context but among all sectors that reported their Q3 2023 results, European Banks, offer a solid alternative with a combination of outstanding fundamentals and currently unparalleled yields across the capital structure.

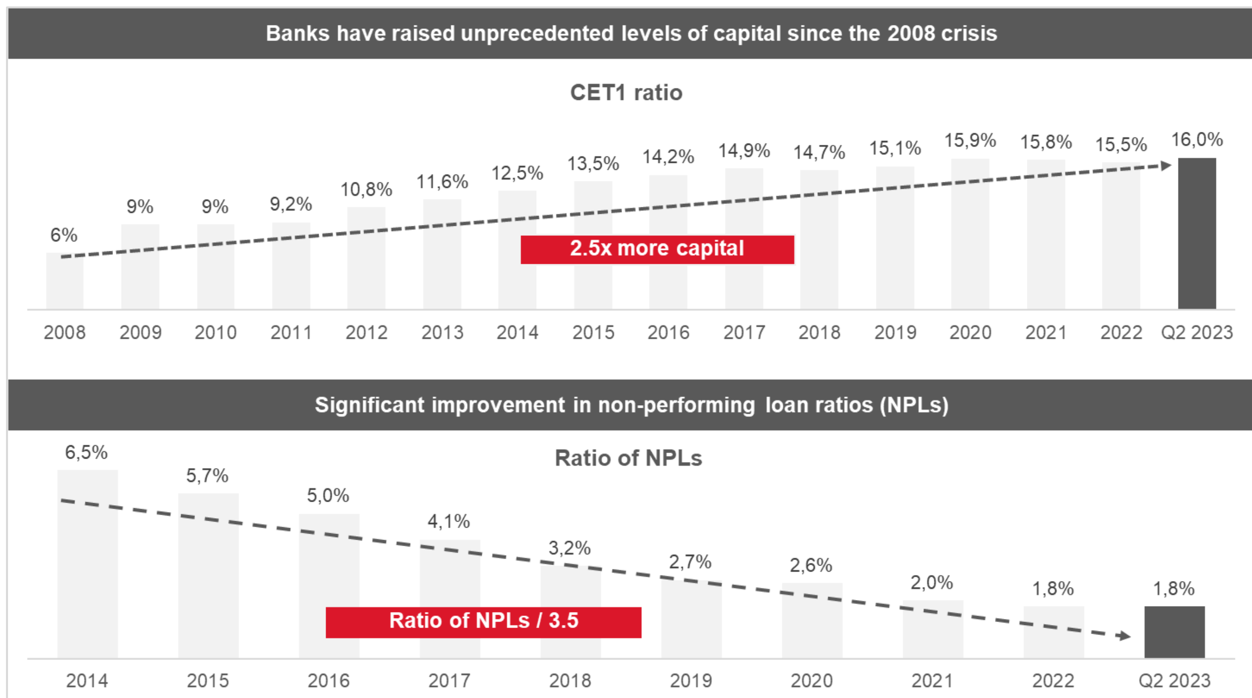
Looking forward, Central Banks in US, EU and the UK, seem to have reached an inflection point in this rate cycle. Investors are expecting rate cuts or at least a status quo. Appealing yields on non-risky assets may substantially diminish sooner rather than later. In that context, asset rotation may become much more appealing for investors. We believe that whether rates will be cut or not, the combination of European banks' fundamentals and valuations offers a unique risk/reward allocation for both equity and credit portfolios in 2024.

European Banks: one of the only sectors benefitting from upgrades on both credit and equity following Q3 2023 reporting.

European banks are exhibiting the soundest metrics since the GFC[1], regulation has profoundly reduced the procyclicality of their business model leaving risky market shares to private credit lenders. The new rates cycle has helped restoring double digit returns on equity. Balance sheets are still run with precautionary provisions inherited from the COVID period.

Capital and Non-Performing Loans (NPLs)

Bank's fundamentals have dramatically changed over the last decade. Capital has gone up and non-performing loans have decreased to their lowest level since the GFC[1] as shown below.



Source: Axiom Alternative Investments, EBA risk dashboard Q2 2023.

[1] GFC : Great Financial Crisis

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Regulatory changes have reduced the procyclicality of European banks.

Business models have been transformed and European banks are much less procyclical than they were, leaving market shares to private credit actors.

Out of the abundant regulatory changes introduced since 2008, three are relevant when it comes to cyclicity.

- First, capital intensity has increased for risky exposures from vanilla lending to investment banking ‘activities.
- Second, a leverage ratio has been introduced to limit balance sheet expansion.
- Third, a net stable funding ratio has been created to limit maturity transforming.

All these changes reduced banks' ability to take risks, leaving market shares to the private credit industry. Private credit funds have expanded massively in the recent years replacing European banks in the riskier part of the lending business. As evidenced by Fitch's report, defaults in the private credit markets reached 1.7% in July, compared with an overall 0.36% cost of risk for European banks. Interestingly, 2023 stress tests offer some evidence of these changes when compared to previous stress tests. 2023 outcome is a lower CET1 impact of -4.6% vs -5% for the 2021 stress test, while simulating a tougher scenario than 2021. We believe at present investors underestimate the long-term consequences of these changes.

Rates just back in positive territory: this is what banks need to maintain double digit ROE

European banks profits have been spectacular for now 11 quarters in a row and investors worry this will fall short. Whilst an average 12% Return on Equity with some banks exceeding 15% is indeed a stellar performance that derives from a currently very low deposit beta (proportion of ECB rates paid to end depositors) and investors fear this could fade away.

But banks don't need rates to be as massively positive as they are today. They just need rates to be positive and ideally the curve to be steep. The 8 previous years of negative rates have forced banks into tight cost and risk management that gives them today some significant room for manoeuvre, making their earnings trajectory more comfortable. Even with higher deposit betas, if rates remain in the positive territory, European Banks Return on Equity should remain at around 10%. And the upcoming changes in the rate cycle could also be further supportive. Banks operate for now with flat rate curve which is not ideal. Rate cuts may likely steepen the rate curve, which would enable them to generate maturity transforming revenues.

Profitability should not fade away unless rates would be back below 0.

Recession fears: some positive legacy from the COVID

During Covid, regulators had requested banks to put aside precautionary provisions that account for in average 0.3% (expressed in percentage of European Banks lending book). This would roughly protect European banks from defaults surging in a normal recession, as they reach in average 0.4%. This should help protecting European banks profitability with significant magnitude. We estimate that Precautionary provision should protect the sector from a 2% in employment rate increase.

With such fundamentals, European banks look attractive on both equity and credit.

Equity: double digit cash yield may again be a key driver in next years' performance

European Banks will offer 11% cash yield in 2024, and some up to 15%. In a global bear market, cash yield may be one of the only things you will be able to rely on in 2024. Beyond supporting yields, the valuation context is also favourable. Over the last 15 years, European Banks have hit lower valuations only 1% of the time. Market sentiment often plays a key role when it comes to European Banks, but in a year like 2023, combining some banking crisis sentiment with recessionary fears, the year-to-date performance stands at 21%. Hence, strong earnings and strong cash yields can defy market sentiment.

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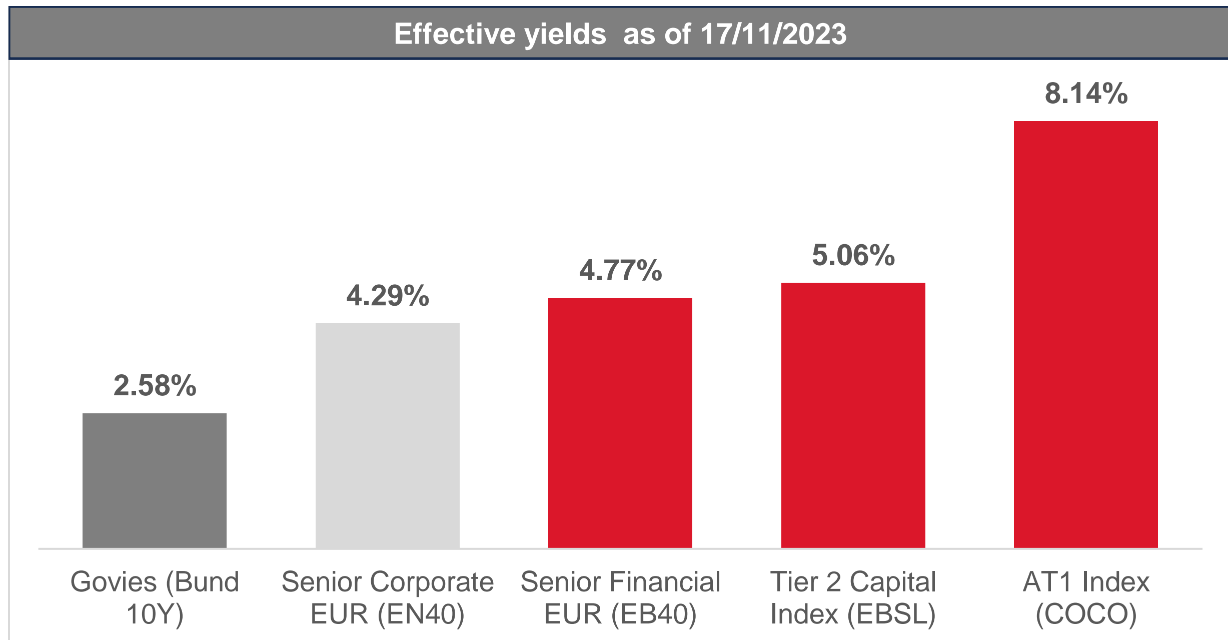
Credit: some light through the macro tunnel.

Financial credit has suffered in 2023 from a very undemanding environment. With rates increases in major currencies, sovereign bonds and money market funds started again to be attractive for Fixed Income investors, rebalancing flows from the credit market.

High Yields credit flows were hence poorly oriented at the beginning of the year. Then, the Credit Suisse event ("CS") accelerated the outflows on the risker part of the capital structure. In parallel, the technical background has been unhelpful with curves inverting post CS until July, and again after the 7th October events.
The combination of outflows in the HY segment combined with unsupportive technical (inverted rate curve) ended up with pressures on prices and higher yields across the capital structure. As I am writing this note this is how broadly the financial credit space companies with corporates and sovereigns.



Source: Axiom Alternative Investments, Bloomberg, Ice Index Platform.

A turn in macro data with more sign that inflation is easing, could encourage fixed income flows. European banks should massively benefit from, on the back of compelling fundamentals.

But if technicals remain unsupportive to the fixed income flows, higher yields combined with strong fundamentals, should offer investor a reasonable performance buffer for 2024.

All in all, whether for an equity or a credit portfolio, we believe European banks offer a compelling risk reward profile for 2024.