

EUROPEAN BANK EQUITIES: CHEAP RATE OPTIONALITY AND RECORD PAYOUTS

A decade of easy liquidity has brought down discount rates, boosting equity market multiples and driving durations to all-time highs. Just when central banks around the world start winding down quantitative easing, stocks with high priced-in earnings growth and distant cash flows are more at risk. **We expect cyclicals to outperform liquidity-sensitive stocks as the monetary impulse wanes and economic growth takes the lead.**

Among them, European banks profit the most from higher interest rate expectations. Though they have rarely looked cheaper versus the broader European markets, with the P/E discount reaching 45% at the end of last year, their upside interest rate sensitivity has rarely been so high. This is due to the negative rate environment and the level of excess liquidity. Indeed, as banks are overfunded and deposits are still paying above the ECB rate, they are highly unlikely to pass on any rate increases to depositors.

On top of the cheap interest rate optionality, increased payout ratios will reduce duration further and should provide a boost to valuations. Marking an emblematic turnaround, European banks are set to pay out more in dividends and share buy-backs in 2022 than before the Great Financial Crisis. We expect them to pay above €80bn to shareholders this year, which compares to a pre-GFC peak of €75bn.

In 2021, bank investors recouped their 2020 losses as fears of high credit losses receded. Analogously, they could hope to recoup their 2018-2019 losses this year as the prospects of a slowly normalizing monetary policy and higher payouts get priced-in again. **In our base case for 2022, we expect European banks to deliver a total return of 20% to 30% percent. We lay out the key arguments underpinning our thinking below. We discuss alternative scenarios at the end of the note.**

1. Though the monetary cycle is slowly starting to reverse, we are still early in the growth cycle

The rise in the cost of liquidity should impact the most aggressively priced segments of the market first, i.e., emerging technology stocks and SPACs. Bridgewater estimates that 10% of the total US market cap today is expected to grow revenues at an annual rate of more than 20% for over a decade. Historically, only 2% of stocks ever achieved this feat, and 0.5% managed to combine fast growth with margin expansion. Interestingly, retail activity has been concentrated on a few segments, with about two-thirds of total 2021 retail flows going to technology, auto companies and airlines. Financials and resources have been among the least allocated sectors. If the bubble turns, retail traders might be forced to reduce their leverage and liquidate their positions, resulting in a relative outperformance of the "unfashionable" sectors. It could have broader implications for the technology giants as well, which drive 10% of their revenues from global startups spending on cloud and online customer acquisition.

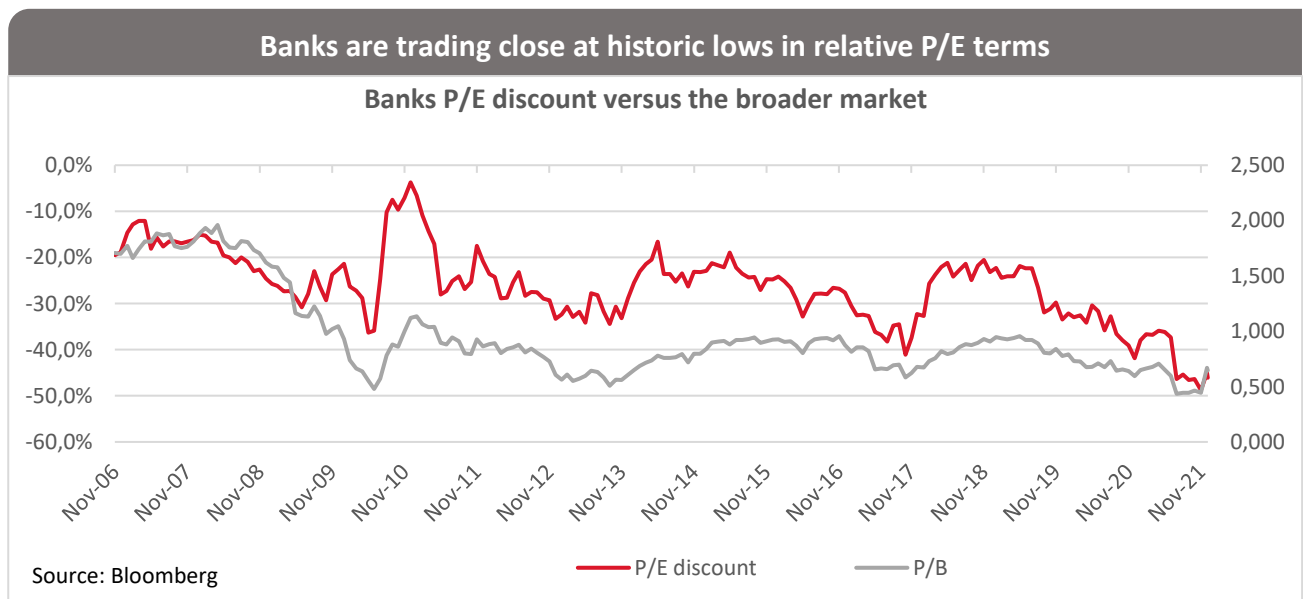
For many companies, the strong economic outlook will be a force that counters the impact of tightening liquidity. Compared to the US, Europe is more skewed towards cyclical businesses, with high operating leverage, and has some of the post-COVID bounce still ahead. In Europe, the household savings rate is still around twice as high as its pre-pandemic level, while it has normalized in the US. The impact of future Covid waves is likely to become more muted overall, as the number of individuals without acquired immunity declines to even lower levels. Though the fiscal expenditures will be lower compared to 2020 and 2021, they will still be significantly higher than their normal run-rate. The job market is hot, with a record number of vacancies on both sides of the Atlantic, but more excess capacity

in Europe. All-in-all, consensus expects real GDP growth figures of 4.2% in the Eurozone, mostly driven by consumption, and 3.9% in the US, mostly driven by private investment.

Some fear a repeat of 2018, with everyone starting the year bullish and finishing it bearish. 2018 was a terrible year for European bank stocks. Stress on Italian sovereign spreads, Brexit negotiations, and talks of an impending recession in the US and China drove a 25% sell-off in the SX7R index when the broader market returned -11%. True, there are similarities with January 2018: growth expectations are high; job markets are closer to their full capacity; central banks are more willing to curb demand; some segments of the credit market, such as US leveraged loans, seem stretched. For European banks, one could argue that credit-loss expectations now reflect the recovery we have experienced and have little room to improve further.

However, there are key differences:

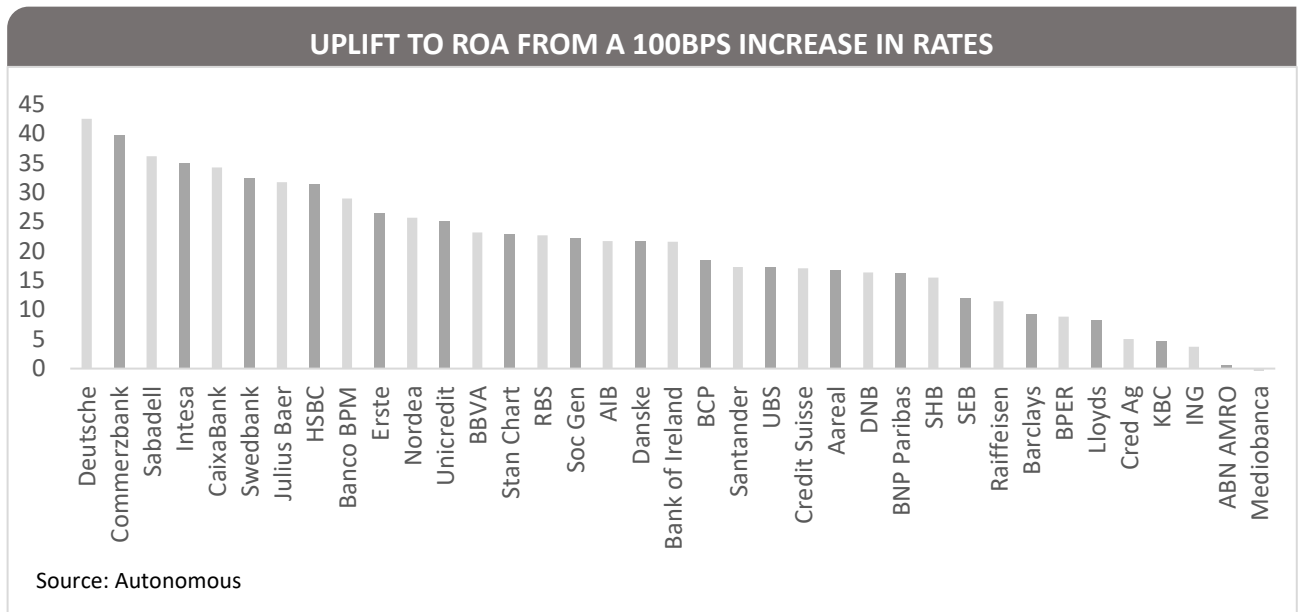
- We are much earlier in the cycle. The European economy has barely recovered its pre-pandemic level and has a lot of catch-up to do, with record excess liquidity to recycle.
- The ECB is determined to keep sovereign spreads under control. It will have the flexibility to reinvest the PEPP balance sheet flexibly across countries, with no capital key constraint. The direction of travel is towards a "put mechanism", i.e. quantitative easing with flexible parameters that would be temporarily deployed in case of market stress.
- Starting valuations are not the same. 10Y and 30Y Euro swap rates were 80bps and 110bps higher respectively. The SX7E was trading around 40% higher than its current levels. In terms of relative valuations, the P / E discount for European banks now stands 45% versus only 20% in early 201



2. Rate dynamics are encouraging for lending margins

Expectations for future rate hikes will be a key driver for bank stocks. In the Eurozone, interest rate sensitivity is higher than in previous cycles due to the negative rate environment and the level of excess liquidity. As banks are overfunded and deposits are still paying above the ECB rate, they are highly unlikely to pass on any rate increases to depositors.

We estimate that banks' earnings would grow on average by 25% in the first 18 months following a 100bps parallel shift in the short/medium-end of the curve, with high disparities (+100% for Sabadell, +5% for Credit Agricole).



The inflation surprise lifted interest rate expectations from their all-time lows. 10Y Euro swap rates are now 50bps higher than their 2020 lows (though they remain 90bps lower than their 2018 high). No published forecaster came close to predicting YoY inflation rates of respectively 7% and 5% in the US and the Eurozone for the end of 2021.

Central banks, though initially dismissing inflationary pressures as episodic, had to review their anticipations. In their latest central scenario, the ECB predicts that "Inflation is expected to be higher for longer but should fall slightly below 2% by the end of 2022 and stand at 1.8% in 2023 and 2024". Crucially, this is very close to the level implied by the forward guidance (i.e. inflation reaching two per cent well ahead of the end of its projection horizon and durably for the rest of the projection horizon), implying that the threshold for raising rates is likely to be met should inflationary pressures surprise again to the upside.

We believe that a confluence of factors should keep driving M/M inflation in Europe well above an annualized rate of 2% for most of 2022:

- Despite Covid constraints on services, labor markets are tight, with a high number of vacancies and unemployment rates close to their post-GFC lows
- European consumers are still saving much more (20% of their income) than they used to (12%) and haven't deployed their pandemic savings into consumption
- Low immunity and rigid Covid policies in producer countries, especially China, will keep supply chains under pressure
- Delays and backlogs have not started to improve yet, though they are worsening at a slower pace

3. Capital market activity and fund flows will remain helpful for fees

2020 and 2021 were both great years for investment banks. In 2020, companies rushed to secure funding in debt markets to weather the economic impact of Covid. In 2021, low interest rates, excess cash and attractive valuations led to a boom in IPOs, M&A and SPACs. Tightening risk premia and high trading volume among a retail-trading frenzy helped trading desks print record profits.

2022 looks promising. The M&A pipeline is very strong. Private equity firms are sitting on record undeployed cash and

face the pressure of capital return. They will likely seek to anticipate central banks tightening and take advantage of current exceptional financing conditions to pursue deals. Though the liquidity impulse will fade, policy will still be highly accommodative for some time, especially in Europe, which should provide an easier environment to navigate for trading desks.

For banks with strong asset management or fund distribution businesses, 2022 should be a positive year, though probably not as strong as 2021. Households have put a lot of money aside in low-risk vehicles such as bank accounts and guaranteed life insurance policies, but the investment ratio is still lagging the savings ratio.

4. Loan growth should pick up, especially in the periphery

Corporate loan growth has long been anemic in the Eurozone. The outstanding amount of bank loans to non-financial corporations has not increased since 2009. This is a combination of deleveraging in some countries (Spain) and an increasing proportion of financing coming from debt markets. As a result, current expectations for corporate loan growth are very low, i.e. close to 0%.

The €807bn Next Generation EU (NGEU) funds are expected to provide a meaningful 1.5% boost to EU 2026 GDP. Assuming a multiplier of 2.5x and a bank financing contribution of 35%, lending could see a 2-3% incremental boost to the otherwise weak underlying private sector loan demand in Spain and Italy. High existing corporate liquidity may mean this will become more visible in late 2022.

US and UK cards could finally start to pick-up as the savings rate has moved back to its pre-pandemic level. This should be positive for banks with significant US and UK consumer finance presence such as Barclays or Santander. In continental Europe, credit cards are unlikely to pick-up before the end of 2022, but home renovation could prove to be a boost following the "home relocation" trend observed in 2021.

In the longer term, the significant investments needed to green the economy and reach carbon neutrality will drive an uptick in the investment / GDP ratio, which is positive for lending growth and Debt Capital Market fees.

5. Record shareholder pay-outs will support valuations

With basic resources, banks and insurance companies are the highest yielding segments in the European stock market. Consensus is pricing an average dividend yield of 5.7% for European banks in 2022 and 2023. This is higher than the post-GFC average of 4% for the sector. In addition, banks have started to distribute their all-time high excess capital. Unicredit rallied by 25% in December as it announced its plan to distribute EUR 16bn (60% of its market cap at the time) to shareholders over the next 3 to 4 years. BBVA and BNP had very strong share performances after they announced the disposal of their US operations and the subsequent distribution of a portion of the excess capital generated. We expect announcements from more banks, especially when they report their FY22 results in early February. In total, we forecast a buy-back yield of 3% for 2022 and 2023, on top of the 5.7% dividend yield. That would translate in pay-out ratios of c. 70% in 2022 and 2023, well above the historical average of 50%. 2023 should see a total pay-out of €85bn, of which €30bn in buybacks.

Importantly, fears over the impact of Basel IV on the level of excess capital have now receded. The full implementation date has been further pushed to 2030, and the risk-weighted assets inflation is now likely to be in the mid-single digits. For banks, it means the capital generated over half a year will prove sufficient overall to address the tighter requirements, which will not be biting until a long time anyway. It seems that global regulators are "done" with the banks and have shifted focus to shadow banking and Tech.

6. Alternative scenarios

Though we are confident in our base case, we recognize that the outlook for growth and rate hikes will remain highly disputed for at least a couple of quarters. We anticipate that volatility will stem from that core macro debate as well as potential external shocks (geopolitics, elections, etc.). More specifically, we will pay a special attention to these 3 topics:

a. The good versus bad inflation debate

Inflation dynamics, and how they are interpreted, will be decisive for markets. The three following scenarios summarize the possible outcomes:

1. Should inflation not be passed to wages, it is likely to erode spending power and lead to lower growth assumptions, and as a result, a lower likelihood of interest rate hikes. This scenario would be somewhat negative for banks, but not cause a dramatic sell-off as current valuations do not reflect the bull case for rates.
2. Should nominal wages follow nominal prices in an orderly fashion, inflation is unlikely to "kill itself" and central banks will have to intervene. As long as it looks like central banks are in control, both short-term and long-term rates will sell-off. This is the most bullish scenario for European bank stocks, and also our central scenario.
3. If rising inflation expectations lead to a self-fulfilling spiral, markets might think that central banks will be forced to curb financing conditions very aggressively, to the point that it leads to a collapse in the economy. Given the levels of government deficits and overall debt, this process would be very painful for all sectors and asset classes (except short-duration inflation-protected, credit-risk free securities such as gold or commodities).

b. Geopolitical shocks

Markets could suffer from drawdowns linked to geopolitical events. The agenda is quite rich with diplomatic tensions:

1. The Ukraine situation may result in an energy crunch and wartime rhetoric. We prefer to avoid banks that are exposed to the region (such as RBI or Sberbank).
2. Tensions in the Asia-Pacific region are rising, with Taiwan in the spotlights. This story will be especially important for HSBC and Standard Chartered.
3. Iran is getting closer to obtaining nuclear weapons. Oil prices could abruptly rise in case war threats in the region materialize.

c. The electoral schedule

There are a few elections coming up. Midterm elections in the US are likely to reduce the room for manoeuvre for Biden. This should be neutral for markets, as tax hikes are viewed negatively but reduced spending expectations could curtail the growth outlook. In France, the uncertainty could rise should the dispersion in candidates' polls decrease and Macron's lead decline. In Italy, a successor to Mario Draghi will have to be designated. The strength of the new German coalition remains untested.



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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.**

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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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