US AND EUROPEAN BANKS

THE OUTLOOK IMPROVES ON BOTH SIDES OF THE ATLANTIC

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SUMMARY

EARNINGS IMPROVE

Although Q3 2017 earnings results were mixed in Europe, compared with a better season in the US, 2017 is still set to be the first year of consistently decent earnings for banks after several years of disappointing results, especially in Europe. The market has noticed the improvement, and the sector has outperformed in recent months.

HEADWINDS ARE VANISHING IN EUROPE

In Europe, where the environment has remained challenging for a long time since the financial crisis, important headwinds have vanished. Economic growth has risen, existential threats to the euro area have dissipated, and balance sheets have improved. The refinement of Basel III (sometimes called Basel IV) by year-end may end regulatory uncertainty, and the interest rate outlook has become a topic of debate. Loan volumes, asset quality and capital returns are improving.

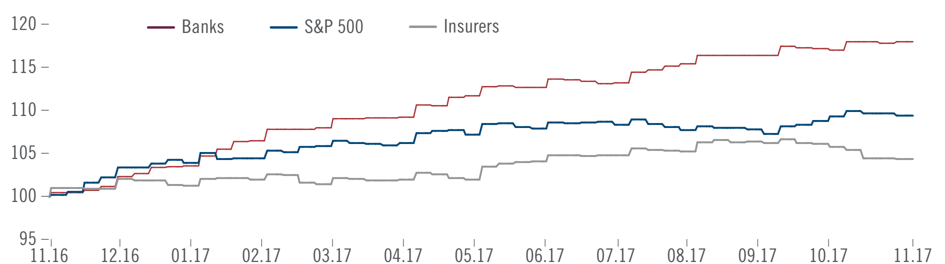
TAILWINDS ARE SUPPORTIVE IN THE US

In the US, which is more advanced in the cycle, a number of tailwinds continue to support the sector, notably rising interest rates (the third hike this year is expected in December) and capital returns (around 7% yield on average). New positives for US banks are also emerging: banking deregulation is gaining momentum and tax reform, if it is enacted and not overly diluted, would boost earnings. Asset quality poses minor concerns thus far.

MACRO VARIABLES ARE FAVOURABLE, VALUATION IS NEUTRAL

Rising bond yields also point to a period of outperformance by banks on both sides of the Atlantic. Valuation is rather neutral. In both the US and Europe, the relative multiple to the wider market for P/E is around 0.75x, which is close to the 10-year average, but below the long-term average of 0.8-0.85x.

CHART 1: US/EUROPEAN 12-MONTH FORWARD EARNINGS REVISIONS



Source: PWM Equity Research, 6 November 2017.

MACROECONOMY
GEOPOLITICS
CENTRAL BANKS
ASSET ALLOCATION
ASSET CLASSES
WEALTH MANAGEMENT

INVESTMENT CONCLUSIONS

We are positive on the outlook for bank stocks, in both the US and Europe. Through the end of the year and into the full-year earnings season, the outlook may be slightly better for US than European banks. Beyond that, macro and micro trends look supportive on both sides of the Atlantic. In the US, aside from tax reform, regulation is a key wild card that could give a further boost. In Europe, an agreement on Basel by year-end would be the last piece of re-regulation post crisis, allowing new investors to take positions in banks.

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EARNINGS RESULTS

Coming to the end of the Q3 2017 earnings season for European banks, it has been a rather mixed quarter. Revenues have been weaker than in prior quarters, due to forex movements (mainly the lower US dollar) and softer market revenues, which is partly seasonal. However, asset quality continues to surprise positively, leaving overall earnings in-line and driving further modest earnings upgrades.

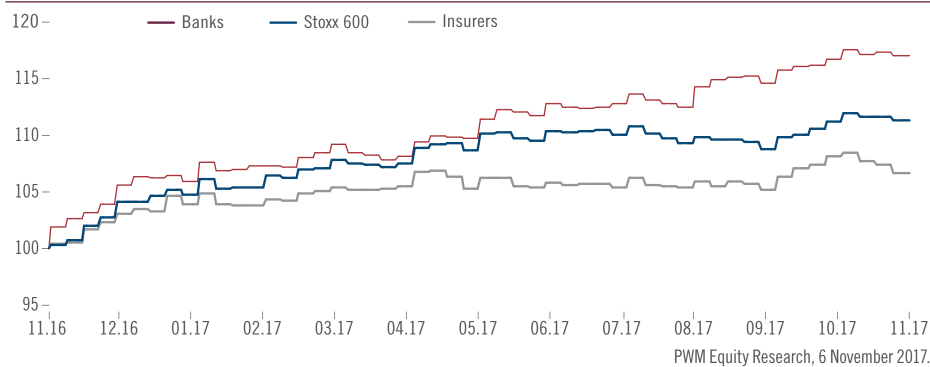
In the US, the Q3 2017 earnings season was better, further supporting the sector's recovery. Net interest margins rose quarter-on-quarter (q-o-q), an improving trend compared to Q2 2017. Against that, volumes remained modest (loan growth up 2% year-on-year (y-o-y)), market revenues were soft, and asset quality was mixed, with deterioration in the credit cards portfolios of some banks (Citigroup, JP Morgan and Wells Fargo). Here, too, the earnings upgrades continue.

This follows strong Q1 2017 earnings for banks on both sides of the Atlantic, and solid earnings in the second quarter. Indeed, 2017 is the first year of consistently decent earnings for banks in both the US and Europe following several years of disappointing results, especially in Europe, and sub-par profitability (with ROEs of 5-10%). Now bank earnings are strengthening across the board, and the market has noticed the improvement. Over a 10-year period, US and European banks still underperform the S&P 500 and Stoxx Europe 600. But on a one-year view, banks outperform in both regions.

> On a one-year view, banks outperform in both the US and Europe

The sector's outperformance also points to an improving outlook for the coming quarters. The table below highlights some of the key reasons, which are partly similar for Europe and the US, but with notable differences.

CHART 2: US/EUROPEAN 12-MONTH FORWARD EARNINGS REVISIONS

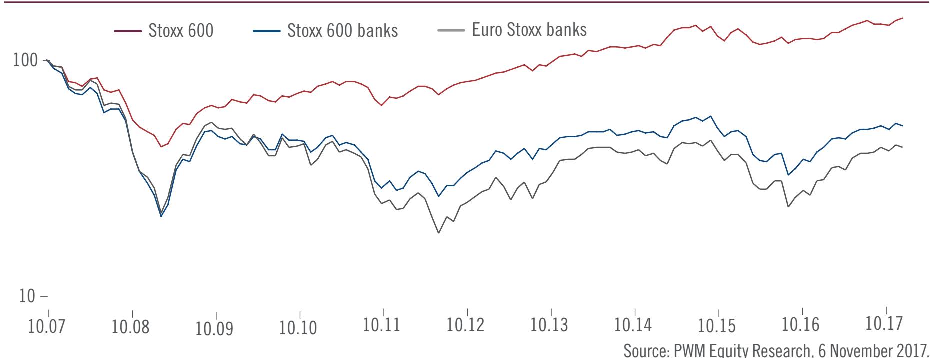


PWM Equity Research, 6 November 2017.

CHART 3: EUROPEAN BANKS, 1-YEAR PRICE PERFORMANCE

Source: PWM Equity Research, 6 November 2017.

CHART 4: EUROPEAN BANKS, 10-YEAR PRICE PERFORMANCE



Source: PWM Equity Research, 6 November 2017.

VANISHING HEADWINDS IN EUROPE

In Europe, where the environment has remained challenging for a long time since the financial crisis, some of the headwinds have vanished:

- **Threats to the euro area.** In the euro area, the crisis in the periphery has now been followed by a notable improvement in growth. The various existential threats to the euro area in recent years, the last of which was the French elections, have dissipated. Neither the recent upheaval in Catalonia nor the upcoming Italian elections should threaten the euro area. The institutional set-up of the euro area still needs strengthening, in our view, through a common deposit guarantee scheme in banking or, even better, euro area government bonds, but at least the immediate threats have receded.

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- **Balance sheets.** At a bank level, weak balance sheets in the context of rising regulatory capital requirements have long been deterrents to investments in European banks. This year, three large European banks (Credit Suisse, Deutsche Bank and Unicredit) have finally raised capital to satisfactory levels. Today, among the 26 listed banks with market capitalisations above EUR 20bn, all have a buffer (at least 50bps) above a CET1 ratio of 10%.

Then there are the headwinds that are about to go.

- **Regulation.** The first, perhaps soon, is regulatory uncertainty, if refinements of the Basel III accord (sometimes called Basel IV) are agreed by year-end, as is expected. These could prove to be the last increase in capital requirements for European banks, to about 10% at the sector level. Crucially, the removal of uncertainty through a new Basel agreement would allow investors to calculate the final capital requirements for each bank, probably allowing more investors to take positions in banks and/or prompting a re-rating of the sector.
- **Interest rates.** The second headwind to go relates to the interest rate outlook. Investors have been speculating about when the ECB would raise rates since March—with some speculation for instance about a one-off hike before tapering asset purchases—and although the timing of the first rise could change, at least there is now a debate. The ECB may keep the deposit rate at -40bps beyond the end of its QE programme, as reiterated by ECB President Mario Draghi on 26 October, but the deposit rate may rise in 2019. That is positive for the bank sector, given that the average European bank's sensitivity to a 100bps rise in short-term interest rates is about 15-20% at the pre-tax profit level.

Beyond these headwinds either gone or about to go, some drivers of recent earnings upgrades should remain present:

- **Loan volumes.** The rebound in economic growth should continue to drive a recovery in loan volumes.
- **Asset quality.** More important for bank earnings, asset quality may continue to surprise positively. This is particularly important for Southern European banks, notably in Italy, where systemic risk has disappeared, but some banks remain at risk.
- **Capital returns.** Finally, with earnings improving, restored balance sheets and regulatory clarity, capital returns should increase. The dividend yield of European banks now stands at 4.1%, surpassing in recent weeks the falling yield-to-call on banks' riskiest credit instruments, AT1. The dividend yield may rise to 4.6% in 2018. If it is lower than that in a year's time, it may be less because dividend expectations have proven over-optimistic again, but rather because banks have re-rated (versus credit for instance).

Against all this, the elevated level of credit and equity markets, which has been a boost to banks' earnings in asset management this year (also helped by low volatility), is perhaps the main risk to mention.

EUROPEAN BANKS

Headwinds gone	No more death threat to the euro area Capital increase done; de-leveraging over
Tailwinds	Loan growth still to recover Asset quality to continue to surprise positively Improving outlook for capital returns
Headwinds about to go	Regulation soon finalised Turn in interest rate outlook

US BANKS

Tailwinds	Interest rates moving up Capital return (total yield ~7%) with upside
Likely positive	Regulation pendulum shift towards less regulation Tax reform Loan growth pick-up
Headwinds	Asset quality to normalise gradually (a few pockets of excess)

TAILWINDS IN THE US

In the US, which is more advanced in the cycle, a number of tailwinds continue to support the sector:

- **Interest rates.** Interest rates, which have been rising since December 2015, are expected to go up for a third time this year in December, and at least once more next year (three times according to the Fed). As rates go higher, the sensitivity of bank earnings to the increases diminishes (at present levels each move up of 100bps lifts US bank earnings by about 8%), but remains positive—in other words, net interest margins will continue to rise.

> The various existential threats to the euro area in recent years have dissipated

- **Capital returns.** Capital returns, through dividends and buy-backs, are another tailwind. The 2017 Fed stress-test has for the first time allowed some banks (Citigroup for instance) to return more than 100% of the earnings they generate. Next year, payouts may increase again, and the limit for dividend payouts could rise at some stage from the current (low) limit of 30%. On average the total capital return yield for the large cap US banks is about 7% (2% for dividends, the rest through buy-backs), which remains attractive in the current market context.

New positives for US banks are also emerging:

- **Deregulation.** Deregulation for banks is one theme gaining momentum, following the US Treasury proposals in June and the more recent appointment of Randal Quarles as Fed vice chair responsible for bank supervision and nomination of Jerome Powell as new Fed chair from February 2018. Their deregulation agenda should help banks reduce costs, liquidity and capital requirements, which could also result in increased earnings and payouts.

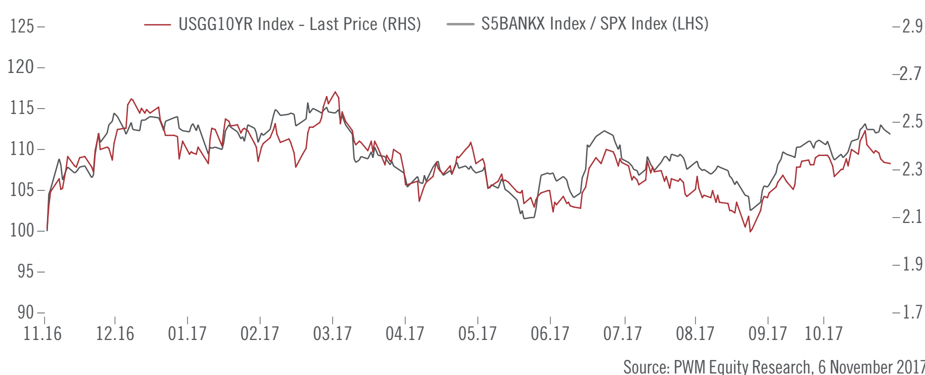
- **Tax reform.** Tax reform, if enacted, would be another tailwind. US financials have higher average tax rates (above 30%) than the market (29%) and more domestic earnings (79%, against 73% for the S&P 500), so should be large beneficiaries of tax reform; as a rule of thumb a 1% decline in the tax rate boosts banks' EPS by about 1%, so a move down from a 35% to a 20% tax rate would give a 15% EPS boost (although such a large cut, at least initially, looks unlikely). The sensitivity is highest for regional banks, given almost exclusively domestic earnings.

> Banks remain a sector whose fortunes are tied to macro and market variables

- **Loan growth.** Finally, and partly related to clarity on tax reform, loan growth, which has consistently disappointed this year and is currently now running around 2% y-o-y, may pick up to 3-4%, which would further help earnings.

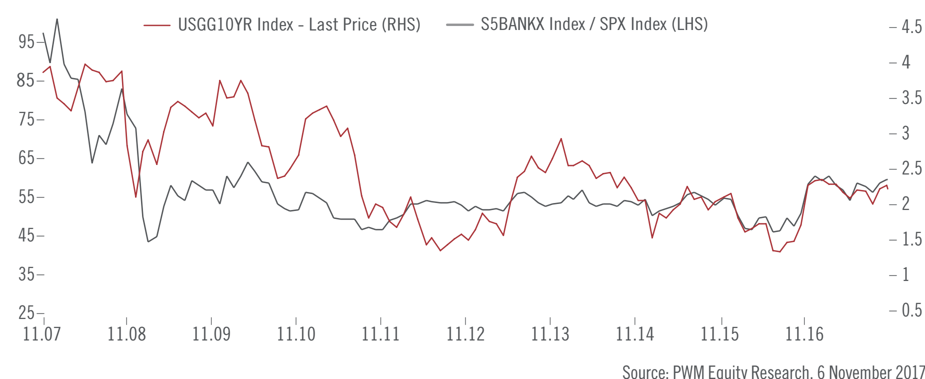
This outlook would not be complete without mentioning one headwind for US banks, normalising asset quality. The economic cycle is maturing in the US, with rising interest rates, and corporate leverage has been increasing to reach high absolute levels. Following several years of very light loan losses for US banks, asset quality is now rising gradually from low levels. Still, there are few pockets of excess indebtedness that are a cause for concern. Credit card losses have been a feature of some banks' recent reporting (Citigroup for instance); overall, these remain low, but they are expected to rise gradually in a slowly rising interest rate environment. Tax reform, if passed, may though improve the outlook for household credit quality through better growth and rising wages.

CHART 5: US BANK STOCKS' RELATIVE PERFORMANCE AND 10-YEAR TREASURY YIELDS, PAST YEAR



Source: PWM Equity Research, 6 November 2017.

CHART 6: US BANK STOCKS' RELATIVE PERFORMANCE AND 10-YEAR TREASURY YIELDS, PAST 10 YEARS



Source: PWM Equity Research, 6 November 2017.

MACRO AND MARKET VARIABLES

So far so good, but banks remain a sector whose fortunes are tied to macro and market variables, so where are these expected to lead? Apart from financial market levels, cited above, the main macro variable to consider here is bond yields, because it correlates well with banks' relative performance on equity markets, in both the short and long term.

There are several aspects to this correlation to address briefly:

- **Adjustment in advance.** First, movements in (market-driven) bond yields often precede those in (central-bank-driven) short-term interest rates, to which most banks' interest rate sensitivity is geared (up to 90% in the case of some US banks such as Bank of America). With rising trends in economic growth and/or inflation, the market often adjusts to the new reality through bond yields first, before central banks adjust policy rates. To that extent, the correlation of banks' relative performance to bond yields just anticipates the interest sensitivity of bank earnings.
- **Value sector.** Second, banks are a value sector, rather than a growth sector like healthcare or technology or consumer staples. When bond yields fall, the future earnings of growth sectors are worth more today, which helps these sector outperform. Little changes from the discounting of profits many years away for banks when bond yields fall, at a time when it helps the growth sectors, but this reverses when bond yields rise.
- **Low-rate environment.** A third aspect to consider is the absolute level of interest rates. The correlation between the banks' relative performance and bond yields is higher (indeed the highest of any market sector in Europe at present) when interest are low, such as now. This can be explained simply; banks make margins on the asset side (in lending

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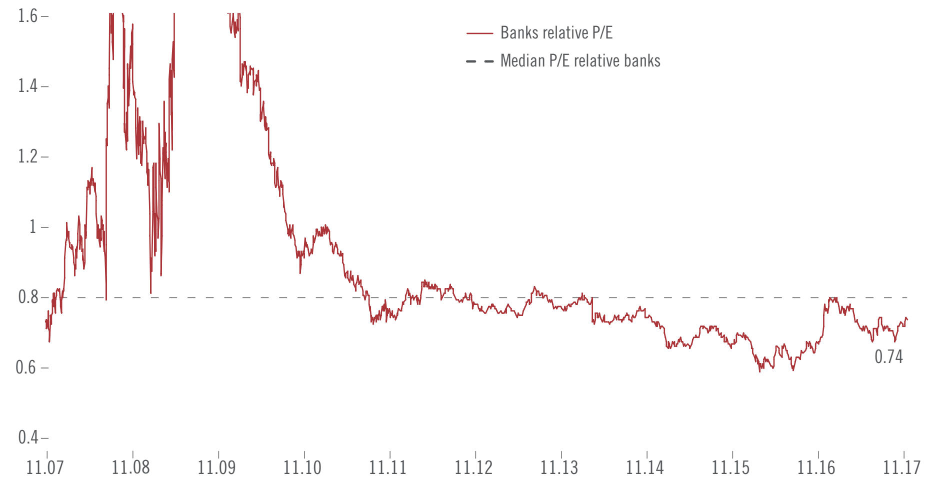
operations) and liability side (on deposits) of their balance sheet. When interest rates are at 2%, if they credit depositors and current account holders 50bps, they make 150bps in deposit margin. If rates drop to 50bps, that margin goes down to zero—unless they pay depositors zero in which case they still make a 50bps margin on deposits. If rates move to zero or negative, banks' deposit margins may turn negative, making it difficult to pay for branch networks, IT and employees and show decent profitability. That tends to increase the bank sector's sensitivity to changes in interest rates, explaining the higher correlation of banks' performance to interest rates when rates are low.

> In the coming months, the outlook may be slightly better for US than European banks

In any case, in the current environment of improving economic growth in the US and Europe, and with central banks reducing monetary stimulus in the form of QE (or even tapering their balance sheet as with the Fed), bond yields are likely to rise. Our forecasts are for a 10-year Bund yield at 1% and 10-year US treasury yield at around 2.6% at the end 2018. That suggests rather a period of outperformance for the banking sector.

CHART 7: US BANKS RELATIVE PRICE/EARNINGS RATIO

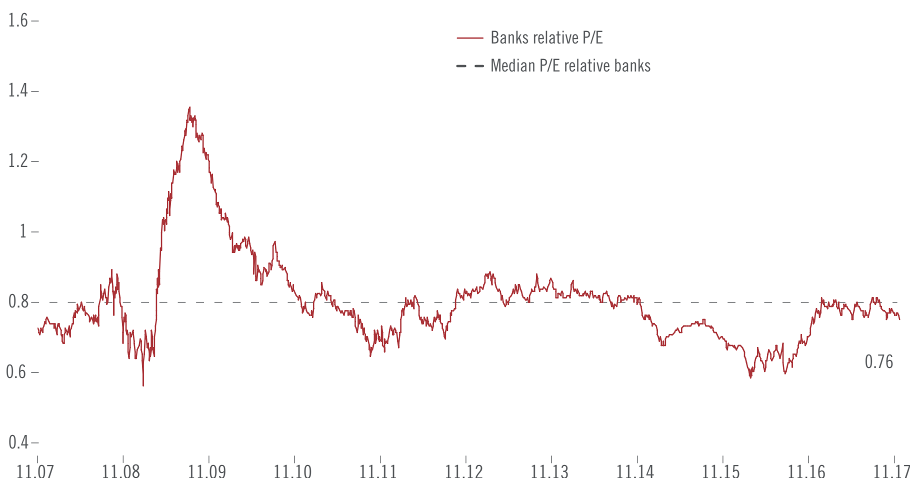


Source: PWM Equity Research, 6 November 2017.

Valuation should also be considered, but is rather neutral. The charts below show, for both the US and European banking sectors, the P/Es at which the bank sector trades relative to the market, on the basis of forward earnings estimates. In both regions, the relative multiple is around 0.75x, which is close to the 10-year average relative P/E. Admittedly, the large discount at which banks traded in mid-2016 relative to the long-term multiple of 0.75x has closed. On the other hand, the 10-year average relative multiple is itself depressed, encompassing only the post-crisis years, and compares to an even longer term average multiple closer to 0.8-0.85x.

Overall, in the coming months, throughout the end of year into the full-year earnings season, the outlook may be slightly better for US than European banks—beyond that the relative outlook is less certain. In the US, the combination of the Fed reducing its balance sheet, more Fed rate hikes, and momentum on bank deregulation and tax reform is supportive. By contrast, in Europe, the ECB's recent dovishness has pushed back the timing of the first move from the -40bps deposit rate to 2019. But the debate on the timing of ECB policy tightening is likely to be revived in the first half of 2018, if the euro area economy continues to surprise to the upside. Regulation is another wild card, as an agreement on Basel by year-end would be the last piece of re-regulation post crisis, removing uncertainty on the sector and allowing new investors to take positions in banks. ●

CHART 8: EUROPEAN BANKS RELATIVE PRICE/EARNINGS RATIO



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