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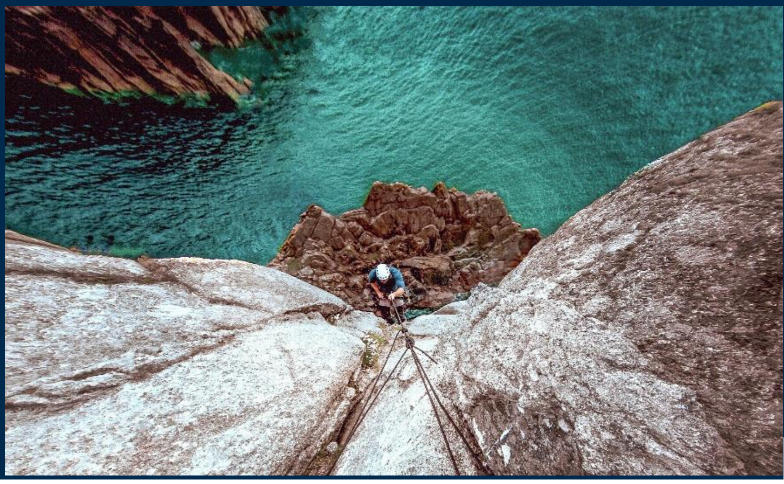
Can the banks deliver for investors in 2024?



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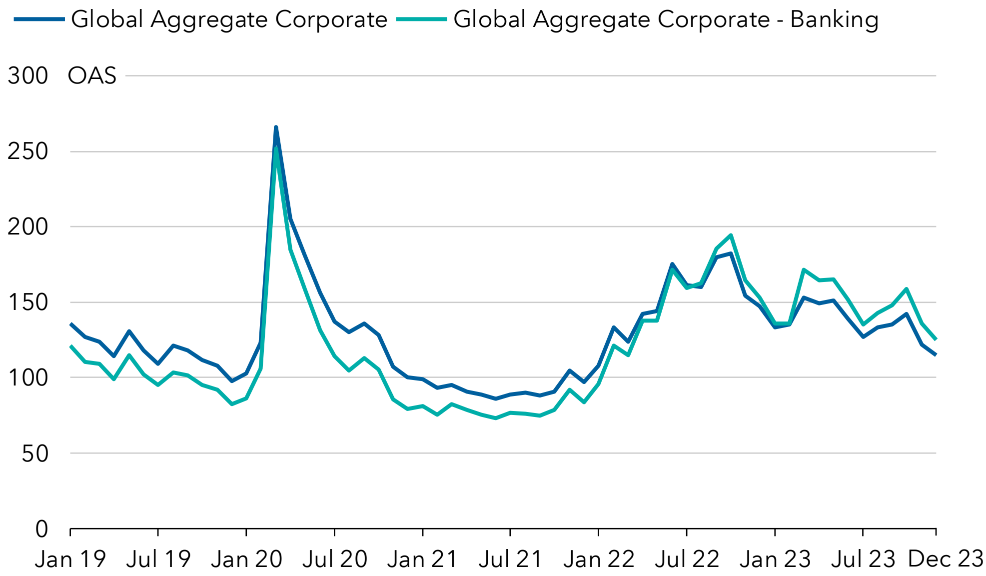
Key takeaways

- Outside of the US regional banks, fundamentals within the banking sector are the strongest they have been in decades, and yet because of high issuance volumes, ongoing concerns over the US regional bank crisis, and uncertainty about the future economic trajectory, they continue to trade wide of the broader corporate bond market. This is unusual, and we believe it provides an attractive investment opportunity.
- The increase in interest rates has been broadly beneficial for banks (except US regionals). Now, as the market narrative shifts towards rates falling and central banks achieving a soft landing, many have interest rate hedges in place to help protect revenues. Given that the market often treats banks as proxies for the macroeconomy, a reduction in recession risk should lead to renewed support for the sector.
- Regulatory changes in light of the US regional banking crisis should keep US bank issuance elevated in the next few years. However, in the longer term, the strengthening of banks' capital positions as a result of these changes should be positive for bond investors. In the meantime, banks have a renewed focus on the quality and stickiness of their deposit base.

Banks are the largest sector of the global investment grade market, representing around 27%[1] of the index by market value. As the below chart shows, the sector begins 2024 with credit spreads wider than the broader investment grade market. We currently have a favourable view of the sector, and any future volatility is, in our view, likely to provide an opportunity to build exposure.

Banks are currently priced with a spread over investment grade credit

OAS comparison of Global Aggregate Corporate – Banking and Global Aggregate Corporate



Past results are not a guarantee of future results. OAS is option adjusted spread.

Source: Bloomberg. Data as at 31 December 2023

In this paper, we answer some of the key questions clients are asking about the sector, including what the macroeconomic outlook means for the banks, the credit implications of the proposed regulatory changes post the collapse of SVB (in March 2023) and the key opportunities and risks facing the sector.

1. Bloomberg Global Aggregate Corporate index

Banks and the macroeconomy

The macroeconomic environment had an important influence on bank credit results in 2023, and it is set to continue to do so through 2024.

Market expectations have shifted from a policy rates will remain higher-for-longer narrative towards anticipating a soft landing scenario in which inflation continues to fall towards target and rates are eased. At the same time, while the global economy has remained resilient and a recession has been avoided so far in the US and Europe, the risk of one occurring has not gone away. Looking ahead, although banks are generally well positioned for all three outcomes, some are more favourable than others.

Higher for longer supports net interest margins

The expectation that central banks would need to keep policy rates high for a prolonged period was the dominant narrative through much of 2023. In general, higher for longer is a positive environment that helps banks sustain higher net interest margins (NIM).

Within this broad picture, there are some important distinctions, however. Banks with an asset base that has a higher allocation to floating-rate mortgages are in a more beneficial position than peers with fixed-rate mortgage books. These differences can be observed at a regional level in Europe. For example, the French banks typically offer mortgages over multiple decades, and as a result, the pass through to revenues from high rates has been much lower for the French banks than for their European peers.

In the US, it is necessary to distinguish between the larger money centre and regional banks. For the money centre banks, higher for longer is a positive environment. However, for the US regional banks, higher policy rates can, at the margin, provide some challenges. This is because higher policy rates increase deposit costs, adding pressure to NIM and earnings. The balance sheets of these smaller banks are also negatively impacted, as fixed income instruments held as assets on the balance sheet are priced lower.

Soft landing: a challenge to NIMs but positive for other income sources

An easing of inflation data through the second half of 2023 shifted the market narrative. There is now an expectation that central banks will be able to achieve a soft landing and begin easing policy this year. The unwinding of the higher-for-longer environment challenges NIMs but provides a more positive environment for banks' other sources of income. There is significant variance within this broad overview.

In regions where deposit bases are less sticky and competition for market share is high, banks need to be cautious about the extent to which any rate cuts are passed through to deposit accounts. This potentially adds to the pressure on margins.

Although a reduction in policy rates will challenge banks' NIMs, it is important to recognise that the NIM is not a bank's only source of revenue. Also contributing to income are fees, commission, asset management and insurance. These other factors tend to be less cyclical and so help sustain the bank's income throughout the cycle.

Furthermore, the recent more favourable higher interest rate environment increased political scrutiny of the sector, and as a result, some European countries have imposed windfall taxes on banks. A lowering of rates could ease some of these pressures. As pressures subside, the proportion of interest rate hikes banks pass through to deposit accounts could also fall. Similarly, the pressure on deposits at US regional banks would be reduced as policy rates fall.

For banks with a higher proportion of assets in variable rate loans, this backdrop would be negative for their existing loan book, however, lower policy rates could boost demand in the floating rate mortgage market. Any increase in loan growth will help to offset the margin erosion from lower rates.

Although falling rates provide a more challenging backdrop, banks can mitigate some of this risk through interest rate hedges. The extent to which such hedges are used varies, both at a regional and individual bank level. In Asia, banks' interest rate hedges tend to be quite short and so will have a less tangible impact on revenues when rates fall compared to their US and European counterparts. In general, however, banks globally have done a good job of hedging their interest rate exposure, and in many cases, are better positioned for an easing of policy than they were for interest rate hikes.

Recession: a challenge for the banks

Banks effectively trade as proxies for the macroeconomic environment. A recession would therefore be a challenge for the sector. Investors would likely want a premium to be exposed to what are highly levered institutions.

Although, fundamentals across the sector are generally good, as a recession scenario started to become priced in, investor focus would be expected to increasingly focus on banks' asset quality and loan losses. The US regional banks would likely come under greater scrutiny and although their fundamentals are in good shape, the perception they are not as stable as the larger money centre banks could mean they underperform. One region where asset quality deterioration may increase in a recession is China, which could see a rise in SME non-performing loans.

Fallout from the mini banking crisis

Tighter regulation

March 2023 saw a mini crisis within US regional banks, beginning with SVB. In the wake of the crisis, regulators proposed a strengthening of the capital requirements for US banks. Among the changes outlined is an extension of the TLAC (total loss-absorbing capital) rules to cover non-GSIB (globally systemically important banks) with total assets over $100bn. This change will require impacted banks to maintain long term debt that could be used in the event of the bank's failure to absorb losses.

In the short term, these new regulations will lead to an increase in the supply of bank bonds, which from a technical perspective is likely to have a negative impact on the bond market. For non-US investors, the increase in issuance will however likely also increase competition in the financial sector for Yankee bank issuance (bonds issued by banks with large US operations but registered in another country). In the longer term, the changes should lead to a further strengthening of banks capital positions, which will be an overall credit positive.

Strategic lessons

How sticky is your deposit base?

The collapse of SVB was in part the result of the rapid withdrawal of its very concentrated deposit base. Data from the Fed shows that 25% of the bank's deposit base was lost on 9 March, with a further 60% scheduled to leave the bank on 10 March. The speed of withdrawals highlights how in an era of digital banking services and social media, deposits are much less sticky, which means bank runs can happen with extraordinary speed.

Cognisant of this, US regional banks are now very focused on the stickiness, as well as the quality, of their deposit base and can be expected to increase the duration of this part of their balance sheets. At the same time, they are also paying close attention to the asset side and want to be reassured they have a sufficient deposit base to support extending the duration of their loans.

The net result of this shift in focus is that in the long term, regional banks are likely to have more asset sensitive balance sheets. This would have a negative impact on their earnings potential in a falling rate environment. However, it will take time to increase the duration of their assets. This is therefore a long term consideration. For the current cycle, they are well hedged and so falling rates will have only a small negative impact on revenue.

Liquidity

Although this was a US crisis, it has important lessons for banks globally. One of the key takeaways is that central banks are now much faster to provide liquidity in a time of crisis. Like their US counterparts, European banks have also become more wary of their liquidity position and its composition. However, European banks are already in a relatively strong position regarding liquidity, with around 80% held in cash and the remaining 20% in global government bonds.

Go local

For banks in Asia, the crisis reinforced a perception that global risks are higher than domestic ones and has therefore limited their appetite for exposure to global markets.

Size matters

Another important lesson from the crisis is that size matters in banking.
This suggests there is a strong incentive for an increase in M&A activity within the sector. The proposed changes in US bank regulation strengthen this argument. For example, a bank with assets of $95-$99bn will face a substantial increase in regulation when it crosses the $100bn threshold. It is therefore not unreasonable for it to conclude that a merger with another to become a $200bn-plus bank is likely to be the more competitive approach.

While M&A is desirable, the current macroeconomic environment makes any such activity challenging and unlikely. The rise in policy rates since 2022 means a lot of banks have significant unrealised losses on the asset side of their balance sheets. Any acquirer would need to put in a substantial amount of capital to plug these holes. The shift from the higher-for-longer narrative has however seen rates fall in recent months. If they continue to do so, these equity gaps will reduce, and banks could start to look more closely at M&A activity, particularly in the US.

In Europe, structural limitations likely curtail M&A activity. There is still no unified banking market to accommodate cross border transactions and there is no European deposit guarantee scheme. Both of these would be a requirement for more large-scale M&A. Meanwhile, in Asia, the benefits of size have long been apparent with the continent dominated by large banks and smaller banks losing ground for a long time.

Investment opportunities and risks

Despite the non-US regional banks having the strongest fundamentals in decades, globally they currently offer a spread over corporate credit. The additional spread reflects the more favourable technicals for non-financial credit, and a market expectation that this will continue as well as ongoing macroeconomic uncertainty and residual concerns about the US regional banks.

Over the past couple of years, bank bond issuance has been high as banks have sought to meet capital requirements. This contrasts with the relatively low issuance undertaken by non-financial corporates and comes at a time when investor demand for duration has been high. The markets expectation is that this dynamic will continue. If it does, and banks continue to issue high volumes of debt with relatively little corporate issuance, then the banks could continue to be priced with a premium over corporates. On the other hand, if bank issuance was to ease then the spread over corporates should narrow.

The other important influence on banks is the macroeconomic environment, with banks frequently priced as macroeconomic proxies. On this basis, as macroeconomic fears recede, the spread differential between banks and corporates should, all else being equal, close. On the other hand, if fears of a recession resurface this would present a much more challenging environment for the banks and would likely lead to further spread widening.

Regional disparities and opportunities

On a regional basis, there is some dispersion. Banks in Asia offer little value at current levels. Chinese banks in particular are priced to perfection. That said, there are still pockets of value, notably in Hong Kong.

There is more opportunity in the US market and a solid Q3 2023 reporting season has helped to assuage concerns about potential further fallout from the regional banking crisis. This has given us comfort to increase exposure, with positions in both the money centre and regional banks.

Arguably the best opportunity is currently in Europe, with European banks trading with wider spreads than both their US and Asian counterparts. This is despite European banks being at the end of the regulatory regime and therefore having high capital buffers and strong fundamentals.

Drilling down further into the European market, we are finding opportunities within Spanish, Irish and Greek banks. These are the banks that were nationalised in the aftermath of the GFC and European sovereign debt crisis. Since then, they have cleaned up their balance sheets, significantly improving their profitability and fundamentals. In addition, to these positive credit factors, the underlying economies of these countries are some of the strongest in

Europe. They all have positive GDP growth, low inflation compared to the wider European Union and corporate and household debt sectors that have undertaken significant deleveraging over the last two decades. These are all factors that bode well for banks' asset quality in the years ahead.

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