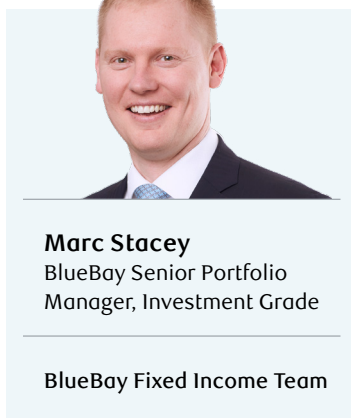


Elevated rates: Now is the time to consider the banking sector



March 2024



Marc Stacey
BlueBay Senior Portfolio
Manager, Investment Grade

BlueBay Fixed Income Team

“Today banks and financials are no longer viewed as the problem they were during the global financial crisis.”

Investment grade financials specialist Marc Stacey, BlueBay Senior Portfolio Manager, delves into why identifying ‘national champion’ investment grade issues in developed markets is a smart decision.

Banking sector resilience

Following the Global Financial Crisis (“GFC”), regulators have spent over a decade rebuilding bank balance sheets and repurposing their business models. Creating a sector with record levels of capital and well-governed management teams. Making banks significantly more resilient than pre-GFC.

Today banks and financials are no longer viewed as the problem they were during the global financial crisis but rather as the primary transmission mechanism for financial policy to reach the real economy.

Furthermore, banks continue to benefit from huge tailwinds of higher rates, with profitability soaring over the last few years. European profitability is up circa 70% from 2020 as at the end of 2023¹.

The result is that banks today are far more robust and profitable than they have been for the last decade. In our view, should a future crisis or global slowdown occur, their strengthened balance sheets and higher capital levels should mean they are far more capable of weathering any potential storm.

In this context we believe that bank debt remains undervalued and provides attractive opportunities for capital appreciation over and above the strong carry component.

¹ Source: Fixed Income Specialisms | RBC BlueBay Asset Management.

What does this mean for investors?

The sector faced several headwinds in 2023. US regional banks were hugely challenged given the large mark to market losses from government bond yields repricing higher. Across the pond, in Europe, a household name that was globally significant effectively went bust over the course of a weekend. All of which understandably rattled the market. Hence why, despite strong sector fundamentals, spreads are as wide as they are today, and why yields are as attractive as they are.

Add to this to the backdrop of higher rates, which banks should thrive in. Even factoring the rate cuts expected by the market, which we think are overly optimistic given the still high core inflation prints, profitability at banks should be circa 50% higher than in 2020².

If we see asset quality start to deteriorate and the cost of risk move higher towards the cyclical average of 50bps per year, this would barely dent the profits being generated.

Even when we model an extreme stress scenario with the worst cost of risk that has been witnessed over the last 10-15 years, which is a cost of risk of 400bps (akin to what was experienced during the GFC), the bulk of the profitability is eroded, as one would expect, but there is little to no impact on the vast amount of regulatory capital that has been built up over the last 15 years, a capital buffer which should be large enough to absorb any macro or idiosyncratic risks which emerge. This makes an investment into subordinated bonds, especially AT1 securities, particularly interesting given the elevated yields on offer.

We believe all of this means that the fundamental resilience of banks is not being reflected in valuations, and we are confident this should correct over time. Leaving open a highly opportune entry point for investors willing to gain an exposure to this space.

² [Source: Fixed Income Specialisms | RBC BlueBay Asset Management.](#)



Portfolio Manager Perspectives

Our experts offer their perspectives on the latest developments in global credit and the state of the markets.

[LEARN MORE](#)

This document was prepared by RBC Global Asset Management (UK) Limited (RBC GAM UK), authorised and regulated by the UK Financial Conduct Authority (FCA), registered with the US Securities and Exchange Commission (SEC) and a member of the National Futures Association (NFA) as authorised by the US Commodity Futures Trading Commission (CFTC).

In the United States, this document may also be provided by RBC Global Asset Management (U.S.) Inc. (“RBC GAM-US”), a SEC registered investment adviser. The entities noted above are collectively referred to as “RBC BlueBay” within this document. The registrations and memberships noted should not be interpreted as an endorsement or approval of RBC BlueBay by the respective licensing or registering authorities.

With respect to the investment performance presented, past performance is not indicative of future performance. Actual account performance may or will vary from the performance shown because of differences in market conditions; client-imposed investment restrictions; the time of client investments and withdrawals; tax considerations; economies of scale; portfolio turnover; the number, type, availability, and diversity of securities that can be purchased at a given time; differences in the underlying currency of the assets in the account, and other factors. Client assets managed using these strategies in separate accounts or different vehicles may be subject to restrictions, fees or expenses that are materially different than those found in the non-US funds.

This document is confidential and, without RBC BlueBay’s consent, may not be (i) copied, photocopied or duplicated in any form by any means or (ii) distributed to any person that is not an employee, officer, director or authorized agent of the recipient.

Information herein is believed to be reliable but RBC BlueBay does not warrant its completeness or accuracy. This document contains information collected from independent third-party sources. For purposes of providing these materials to you, neither RBC BlueBay nor any of its affiliates, subsidiaries, directors, officers, or employees, has independently verified the accuracy or completeness of the third-party information contained herein.

The information contained herein does not constitute investment, tax, accounting or legal advice. Recipients are strongly advised to make an independent review with their own advisors and reach their own conclusions regarding the investment merits and risks, legal, credit, tax and accounting aspects of all transactions. Any risk management processes discussed refer to efforts to monitor and manage risk but should not be confused with and do not imply no or low risk. No chart, graph, or other figure provided should be used to determine which strategies to implement or which securities to buy or sell.

Copyright 2024 © RBC BlueBay. RBC Global Asset Management (RBC GAM) is the asset management division of Royal Bank of Canada which includes RBC Global Asset Management (U.S.) Inc., RBC Global Asset Management Inc., RBC Global Asset Management (UK) Limited and RBC Global Asset Management (Asia) Limited, which are separate, but affiliated corporate entities. ® / Registered trademark(s) of Royal Bank of Canada and BlueBay Asset Management (Services) Ltd. Used under licence. RBC Global Asset Management (UK) Limited, registered office 100 Bishopsgate, London EC2N 4AA, registered in England and Wales number 03647343. All rights reserved.

RBC Global Asset Management (U.S.) Inc.

Minneapolis | Boston | Chicago

800.553.2143 | rbcgam.com

