RBC Global Asset Management

European Banks

The sun is still shining in Autumn

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"The call on further rate hikes may be much more symmetric, deposit betas have remained very low, at 18%."

In July, we looked back to the first half of the year and the dichotomy of several bank failures in a sector that continued to go from strength to strength. With Q2 numbers, stress test results and updated management outlooks, we now look ahead to the remainder of the year and continue to be extremely optimistic for the sector over the next 12-8 months.

In line with our expectations, Q2 results were particularly strong, with 95% of banks beating (rising) consensus earnings expectations for the 10th quarter in a row. Before the summer, we highlighted that the market, and indeed company management teams, seemed too pessimistic with respect to net interest income driven by rising deposit betas. Analyst expectations were for betas to reach 40-50% by the year-end, which seemed conservative to us.

Indeed, while the call on further rate hikes may be much more symmetric, deposit betas have remained very low, at 18%. We continue to be of the view that the terminal point for betas will remain well below what analyst expectations are expecting, even for 2023, and so will continue to be a strong upward driver to earnings and earnings expectations as we look forward to the rest of the year.

Are clouds on the horizon?

Asset quality has also remained robust. Clouds may be starting to show on the horizon, but again, non-performing loans remain very benign and below very conservative management guidance and the expectations of market participants. On average, Q2 bad debt charges were 30 basis points (bps), with a normalised level for the sector expected to be closer to 50bps. Notwithstanding this, 67% of the provision charges taken have related to precautionary provisions rather than non-performing loans, adding to buffers on which banks can draw in response to any economic pressures ahead. We don't expect provisions to remain this low but certainly over the summer, management teams grew more confident in the near-term outlook, with several banks shifting guidance to the bottom end, or even below, guided ranges.

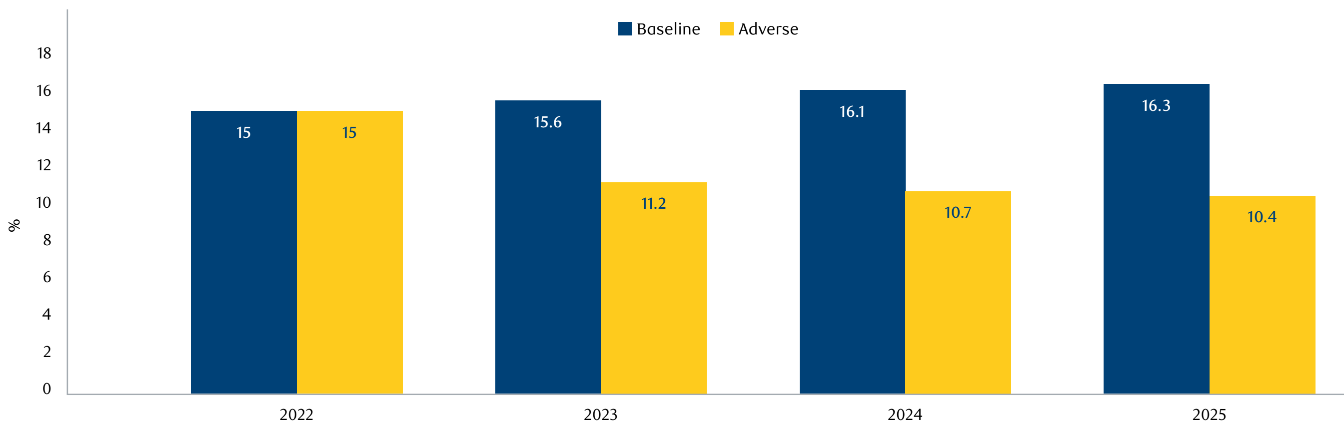
Stress tests are promising

The bi-annual stress test results released in the summer were also very reassuring. The adverse macroeconomic scenarios of the test were the toughest we have seen, with GDP down 5.9%, unemployment rising to 12.4%, house prices down 20% and commercial real estate (CRE) down 29%. Despite this, the drawdown in Common Equity Tier 1 (CET1) was below what we have seen in previous tests, driven by the much stronger starting point for the sector and the higher interest rates driving earnings, which can be used to absorb losses.

As a reminder for context, previous peaks in 3-year cumulative provisions versus the stress tests look very realistic as a worst-case scenario, and we remain on a quite different trajectory (certainly for the time being) to the adverse case scenarios in the tests.

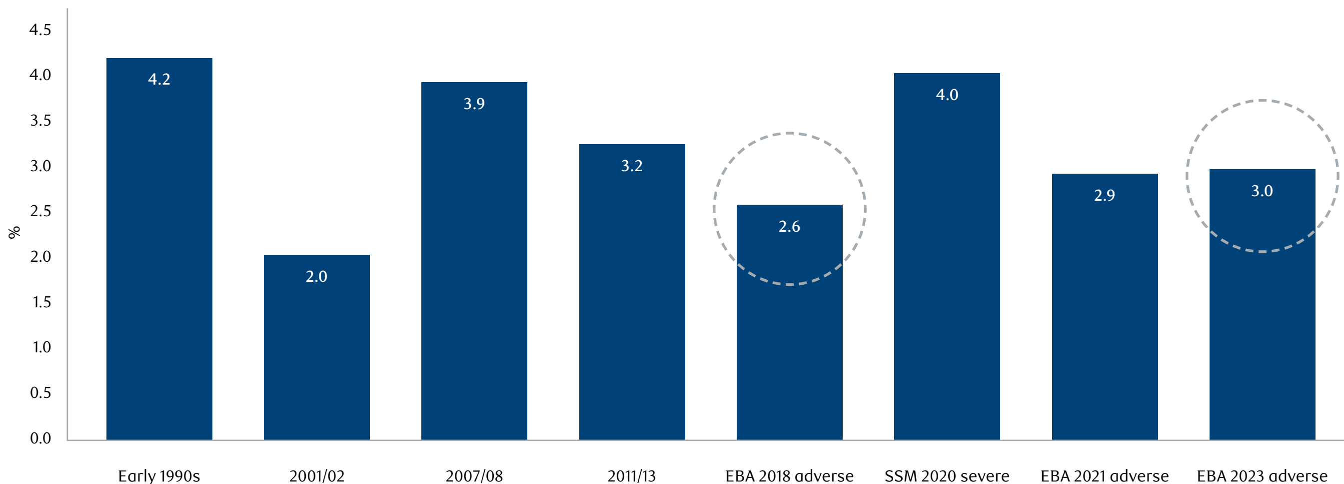
> **"Previous peaks in 3-year cumulative provisions versus the stress tests look very realistic as a worst-case scenario."**

Exhibit 1: The fully loaded CET1 ratio declined by 459 bps in the adverse scenario to 10.4%



Source: European Banking Authority (EBA), September 2023.

Exhibit 2: 3Y cumulative provisions in previous recessions and stress tests



Source: Company data, EBA, ECB SSM, Autonomous Research estimates, September 2023.

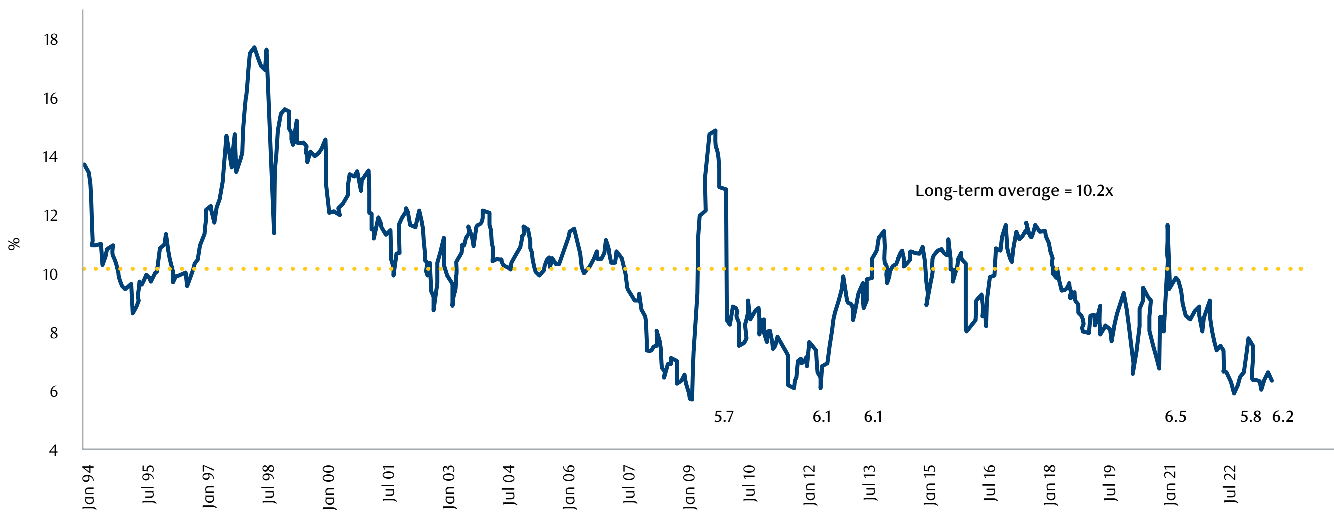
Share buyback programmes support the positive mood

Investors were not the only parties that appear to have taken comfort from the stress testing exercise. Numerous supervisors have been on the tapes over the summer months, highlighting the sector's resilience. In line with the adage that actions speak louder than words, we have also seen numerous large share buyback programmes approved over recent months, with more expected as we go through the remainder of the year. Indeed, the quantum of shareholder returns is now higher than pre-2007 levels, and capital levels continue to trend upward. For the first time in history, buybacks are reducing the outstanding share count of the sector, which should be supportive for bank equity.

Valuations are still disconnected from fundamental strength

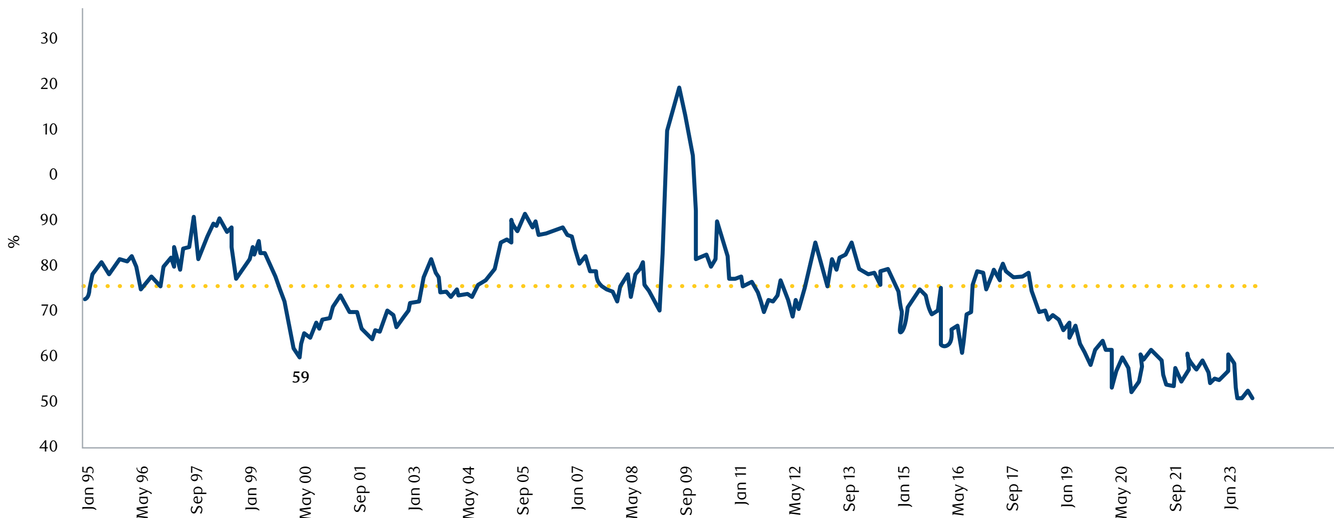
Despite these positive vibes and the market moving on from the events of March, the sector's valuations, in our opinion, remain at a significant disconnect from its fundamental strength. Equity valuations continue to trade at historic P/E and relative lows despite the continued earnings upgrades. Although somewhat recovered, credit spreads, remain extremely elevated and close to the wides of the past three years despite the clear evidence of balance sheet strength and resilience.

Exhibit 3: Based on Y+2 estimates



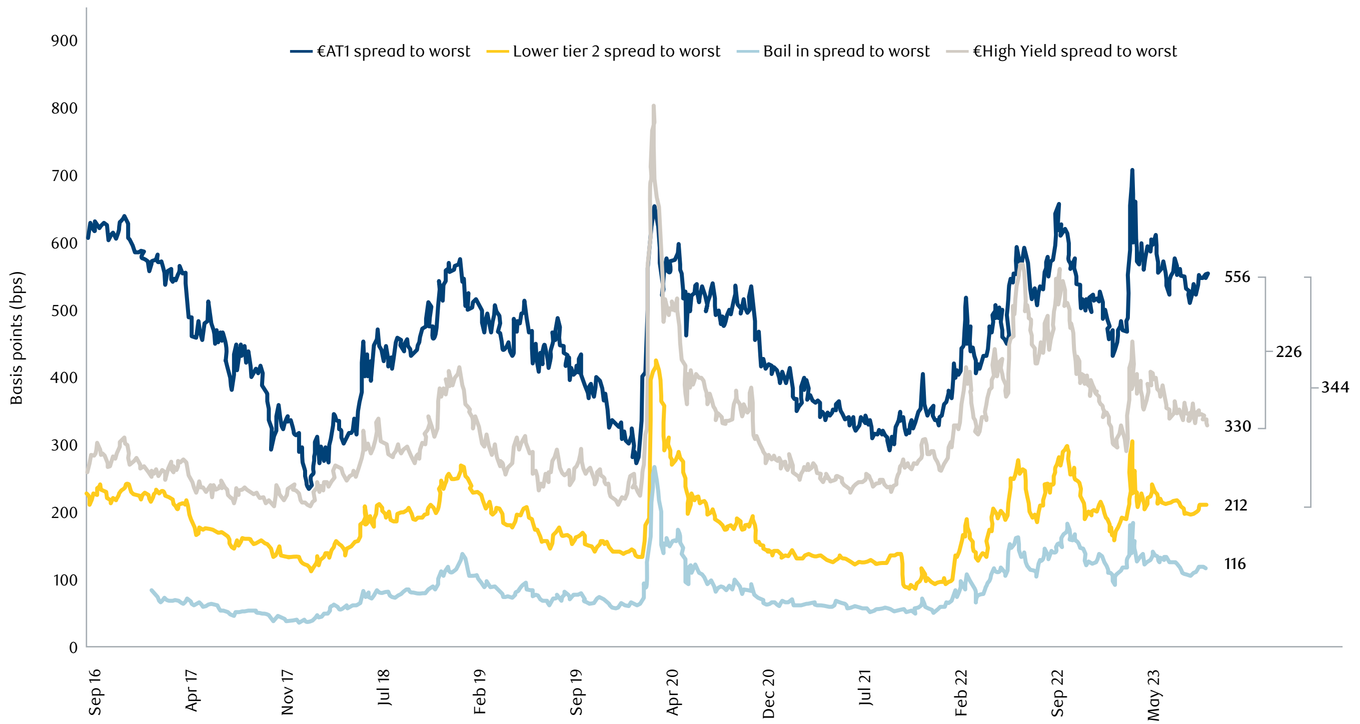
Source: Datastream, Bloomberg, September 2023.

Exhibit 4: Based on Y+2



Source: Datastream, Bloomberg, September 2023.

Exhibit 5: EUR AT1 vs LT2 vs SNR Ball-in vs EUR HY BB (spreads)



Source: JP Morgan, 11 September 2023.

Looking ahead

While market pricing is dynamic and constantly evolving, fundamentals always exert themselves over the longer term. With this in mind, we believe European banks have a very attractive risk-return opportunity over the coming months. We see nothing on the immediate horizon to derail that view.

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