PGIM FIXED INCOME

All the Credit®, Ep. 45

Transcript

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Female Voice: You're listening to *All the Credit*®, a monthly podcast series brought to you by PGIM Fixed Income, an active global fixed income investment manager.

Michael Roper, CFA, European Investment Grade Corporate Bond Portfolio Manager: Hello, and welcome to *All the Credit*®. I'm Michael Roper, a European Investment Grade Corporate Bonds Portfolio Manager here at PGIM Fixed Income, and I'll be your host for this episode of *All the Credit*®. Today, we're going to explore the European banking sector. In our recent *All the Credit*® episode, *Opportunities in High-Quality Credit*, we outlined why we continue to find U.S. money center banks an attractive subsegment of the U.S. investment grade corporate market, especially when compared to the likes of mid-BBB industrials. And today, we wanted to broaden out that discussion around the relative attractiveness of banks to those in Europe. Before diving into the discussion, I thought it would be worth just refreshing our base case macro scenarios. We've detailed a scenario in the U.S. of higher for longer rates, economic resiliency with recession risk falling, and gradual disinflation with inflation expected to remain above target in the near term. Now the key difference here between the U.S. and Europe is the growth outlook. We anticipate the Euro area economy to grow at 0.5% both this year and next, and it is the fragility of that growth backdrop that I think makes a discussion around European banks at this juncture very interesting. Now I plan to structure this podcast in a couple of stages. First, we're going to refresh our bottom-up thoughts on European bank fundamentals, and crucially where we think they're heading, before then opening the discussion to consider the perception of risk and relative value between U.S. banks and European banks from a U.S. market standpoint. And finally, it's worth pointing out that this episode is being recorded ahead of European bank third-quarter earnings. Now to help drive our discussion on European banks, I'm very fortunate to be joined by two close colleagues. First, we have Chris Alquiza, a U.S. Investment Grade Corporate Bonds Portfolio Manager, focused on global corporate bond strategies. Chris is based out of our Newark, New Jersey headquarters. Thanks very much for coming on the show.

Christopher Alquiza, CFA, U.S. Investment Grade Corporate Bond Portfolio Manager: Thanks, Michael. Excited to be here.

Michael: And James Hyde, who is a European Investment Grade Credit Research Analyst here at PGIM Fixed Income. He's been covering European financials for an awfully long time and is based in our London office.

James Hyde, European Investment Grade Credit Research Analyst: Thanks for having me on, Michael. It's a pleasure to be here.

Michael: So, James, let's dive into the fundamentals. I first want to start with your thoughts about the earnings outlook for European banks. Much is often made about balance sheet metrics such as capital and liquidity, but as a first line of defense and a nod to a good business model, do you think European banks can sustainably generate organic capital over the next couple of years?

James: Well, Michael, this so far is a year combining the best earnings-driven capital generation that we've seen since the global financial crisis. And it combines that with a more meaningful giving away of some of that to long-suffering bank shareholders. So, we went into the year with expectations that there would be a jump in interest revenues and with them earnings. But that should have started to fizzle out by the second half of the year. That fizzling out had been on the assumption that banks would have to pass on more of the rate rises to customers. This is the so-called deposit beta issue. And worries about that had intensified with the whole U.S. regionals episode, Silicon Valley Bank, and the Credit Suisse one on this side of the pond. However, it has worked out better than expected for European banks. In the Euro area, for instance, by August, the pass-through of the cumulative 425 basis point rise in the ECB rate was way less than a third of that. And really, all the indications for the third quarter so far is that there is no big increases in the pass-through yet. At the same time, cost control seems to be pretty good. The drop in credit demand by good quality borrowers that is a natural consequence of what you highlighted about European macro scenario is also a concern going into 2024. But where we are more watchful on revenues and earnings before credit risk revisions is the impact of political reaction to European banks having had a big rise in profits, while the public is hurt by higher rates and inflation. There are windfall levies or taxes introduced or proposed in a number of countries. And governments and the European Central Bank are taking some measures which will likely hurt profitability, possibly in terms of ramping up the European Central Bank's reserve requirements. But also, just today, we have the prospect of the European Central Bank offering a digital currency alternative from 2025. And that could eat into revenues, earnings, and liquidity. Overall, though, the message for this year definitely remains one where banks have optionality to build capital or step up share buybacks and dividends, or a combination of both. This is, of course, absent a major deterioration in asset quality and cost of risk.

Michael: Great. And it feels like to date, then, that the higher rates have been a net positive in terms of bank earnings. But equally, when we talk about higher for longer rate scenario, it is a nice segue into asset quality. And I've found it difficult to square all the headlines around the impact of higher rates on things like commercial real estate valuations. I think it was only the last week the ECB were out asking lenders about how they value CRE on balance sheets. And yet we're still seeing pristine bank asset quality. So where do you see the most likely pockets of risk emerging in the European banking sector? And how much of a worry is it?

James: Yeah. Well, so far, it has been miraculous, I guess, almost. We've still got a flat Europe-wide non-performing loan ratio and an annualized cost of risk that is just 26 basis points. That's over half what you would expect through the cycle. And it hasn't gone up. Now, yes, commercial real estate. So far, the hit has been actually in their Asian operations for the well-publicized problems in China. Recognition of problems at home does not seem to have yet made a mark. Part of the reason for that is that the proportion of lending, that is to commercial real estate in the books of banks, is less than 8% on average. That's half the level it was in the global financial crisis. Now, partly, this is because of the increased replacement of bank debt by bond market debt for European commercial real estate investing and renting companies. Now what we're watching very carefully is these borrowers' inability to refinance bonds at maturity at any economic rate. And with that, what would the fire sales do? And what does it do for the banks who still maintain relationships with those companies that are finding difficulties? And of course, there is always unsecured consumer debt. Generally, it's nothing as a big area of lending as in the U.S., but we need to be watchful. And we do see some complacency there.

Michael: Can I just push you briefly on UK banks specifically? And you have the narrative of higher interest rates, mortgages rolling off fixed rate periods, as well as economic concerns about the UK. How do you see UK bank asset quality? And do you think these residential mortgage portfolios will show any sign of stress?

James: Well, again, before these third-quarter results, what we did notice is that the UK banks exceptionally had a recent uptick, especially in the second quarter, on the usual non-performing loan and cost of credit risk charges. Less than had been expected, definitely. But one of the big comforts is that the reserve coverage, the amounts of set-aside for potential problem loans is higher than pre-pandemic and is higher than elsewhere in

Europe generally, too. Now, unemployment and historic lows clearly helps. So, at this stage, the impact is limited, thanks to that, where in some cases, you've had households whose debt servicing burden for the mortgages has increased by even 50% in some cases. There was a big switch to fixed rates, relatively short fixed rates, and that has been helpful. But as those fixed rates come to renewal, then the problems could emerge. But it is helpful that now, I think for about nine or more years, any new mortgages have been only granted after a stress test of a big rise in rates. Now, we may be getting near the way that rise was in that test, but that is certainly helpful. Consumer unsecured in the UK, I would say that is the one market where it is a worry as well.

Michael: So, we've kind of touched about the impact of higher rates on both earnings and asset quality. If we rewind back to March and some of the deposit outflows experienced by U.S. regional banks, that also demonstrated the risks of higher interest rates from an asset-liability mismatch perspective. Perhaps you can just elaborate a little bit on why deposit bases have proved stickier in Europe and how comfortable you are at the moment with European bank liquidity positions.

James: Yes, very good question. Now, first of all, I should say that we did have declines in outright deposit volumes at the end of 2022 and the first quarter of 2023. But this was not really related to any panic that arose after Silicon Valley Bank, U.S. regionals, and Credit Suisse. It was really a change in corporate behavior. Once you get some serious interest rates, those corporates are kept precautionary big amounts in deposits and had loans decided to net that off as much as they could. This actually stabilized in the second quarter. And behaviorally, of course, there is a difference. The money market funds are neither as well established nor have enough investable assets once customers put money into them. So, they're just not as promoted as in the U.S. where you've got much bigger commercial paper markets, etc. So really—actually, the risk, again, is a political one at this point, what we're seeing. Firstly, we've got some governments whose debt issuance needs have really been going up, are beginning to appeal to savers, sometimes with language saying, you know, "Why are you being cheated on by the banks?"

Michael: We saw a great case of that recently in Belgium.

James: Oh, gosh. Yes. They thought they'd get in about five billion and they had 22 billion, and it did cause a problem for some of the smaller banks. And of course, the government didn't know what to do with 22 billion, so it went straight back to the bank sector, except the bank sector paid more for it. And we've had that in Italy. In Italy, not so much political, but it's a restart of something they had. So, there is that. And then there is also what the European Central Bank has been doing because it really did bleed in terms of its possible capital situation in the era when it was providing so much liquidity and is trying to make up for that through various measures involving minimum reserve requirements. And today, very topically, they've announced a scheme to start central bank digital currencies, which could take away transactionally deposit money from the banks, which could cost them, but that's a 2025 possibility. But that said, you know, liquidity has proven to be a lot more resilient than expected. You had a half a trillion repaid from the long-term facilities that the ECB provided and extended and extended through the various European crises. That was repaid, and the net decline in the system's liquidity or the bank system's liquidity was a quarter of that. Partly that's because there were precautionary measures lining up collateral. In all this liquidity coverage ratio which came to the fall in this Silicon Valley bank problems, it just fell from 152 to 150% in Europe on average by our calculations.

Michael: I just wanted to jump in and ask. When you're thinking about liquidity metrics from a bottom-up perspective, how has your approach evolved when you think about bank runs, for example, being accelerated by digital innovation?

James: It certainly made me rethink what is a quality deposit, and private banking, you always thought was fairly solid, but you realize much more the wealthier type of deposit and savings gatherers can be very vulnerable. In terms of digital assets, we hadn't seen much, despite a number of challenger banks, especially in the UK. I think the trust has not been there. I think there has been a bit of convenience, transactionary amounts that have gone in, but it hasn't had that impact. Of course, the internet making a possibility of switching at a click is something we have to watch. And yes, theoretically, deposits that are above the deposit guarantee scheme amounts could fly quite easily. So, we have looked at how much of a bank's deposit is under the guarantee scheme, and we've ranked banks qualitatively with that to a certain extent.

Michael: Great. And then finally, I just thought it'd be worth touching on the sovereign bank feedback loop here in Europe, especially as the BTP boom spread starts to come under a little bit of pressure. I think today, we're at around 200 basis points, still a long way off where we were in 2011 during the peripheral debt crisis. But I think it'd be interesting to the listeners to know how you think about transmission channels between sovereign and bank at this juncture.

James: The interest of the banks that suffer from this, the Italian banks in particular, has been to try and get Europe to move towards a single deposit guarantee scheme. So, the banks are not as affected by certainly wholesale funding cost spikes when there is concern about an individual's sovereign borrowing credit metrics. Before that, they've actually had to make an effort to minimize the risk from their own national governments, which has been the natural place for any excess liquidity that they have. They have diversified and they have reduced the actual duration risk, as we call it, on these. So, I mean, the prime example we have are of the two largest Italian banks. And these holdings are currently an average of just under the 75% of their core Tier 1 capital, the most important measure of capital. That is a half the level of most of the previous decade with all the sovereign crises. And it's actually with the risk involved in those positions, the sensitivity to this core equity capital ratio of each full percent or 100 bps of widening is now an average of 20 basis points on that ratio. That is a lot more absorbable than before. So that is helpful, certainly.

Michael: Thanks, James. To conclude, it feels like we remain comfortable at this juncture with European bank credit fundamentals. It feels like we're starting in a strong place and we're certainly not complacent about potential headwinds, namely that it feels inevitable that asset quality has to deteriorate slightly from here. But it's worth reiterating that European banks are in a very different place than they were in the great financial crisis. And I think that's a great point to turn the conversation over to Chris in the U.S. to get a U.S. investor perspective on the space. So, perhaps, Chris, I can ask whether the narrative that James has just walked through—is that consistent with the messaging you hear in the U.S. around European banks or is there a slightly different perception?

Chris: So, the perception has certainly improved over the last few years, given the underlying progress in the fundamentals. That said, in times of volatility, we tend to see spreads between European and U.S. banks decompress. There are a few reasons for this. First, we have a natural home country bias. Second, many European banks issue in 144A Reg S format, which is not included in some major indices. And lastly, and probably most importantly, you've had to contend with very unique events over the years. So, you had Euro debt crisis, confidence crisis at Deutsche Bank, Brexit. You've had fairly contentious political environments in France and Italy. And most recently, you had the forced rescue of Credit Suisse in March. So that's quite a storied history over the past 10 years and definitely warrants additional spread compensation. But as you've just heard from James, the fundamental analysis shows a significant improvement over the recent years in asset quality, capital, liquidity, and even profitability, which European banks haven't traditionally been known for.

Michael: And if we rewind back to March, April of this year, there was plenty of turmoil in the banking sector. You had UBS's forced rescue of Credit Suisse and then also the regional bank crisis going on in the U.S. Perhaps you can detail a little for us how the trading relationships between U.S. money centers, regionals, and Yankees were before those events and how they might have changed in the past six months or so.

Chris: The average Yankee bank trades about 34 basis points behind the U.S. money centers, which is pretty close to the tight end of the range over the last 12 to 18 months. But when you look over the last five years, we're probably closer to the middle of the range, which would be about flat to maybe 70 basis points behind the money centers. So, while we see value in current spreads over the medium term, we do want to keep some dry powder to deploy should the macro headwinds accelerate. In regional banks, though, we've seen a massive repricing. Before March, they traded as much as 30 basis points inside the U.S. money center banks. Historically, they benefited from smaller debt footprints, and we were happy to be underweight, given our view of the relative credit quality. But now, the super regionals, U.S. Bancorp, PNC, and Truist, they sit around 40 basis points behind the U.S. money center banks, while the next tier, the likes of Fifth Third, Citizens, and KeyBank, sit anywhere from 50 to 100 plus basis points behind the U.S. money centers. And we've been opportunistically adding exposure in select names.

Michael: I'm going to push you on this point a little bit further because we obviously sitting in Europe have a slight bias towards banks in our jurisdiction. But I'd love to know a little bit more about how you think of the relative value between European banks and specifically regionals in the U.S. market.

Chris: That is a great question and one we debate internally. We often see the market paint a broad brush on European and UK banks, which we think presents opportunities to invest in national champions at attractive valuations. If we compare top-tier European banks to U.S. regionals, you're typically larger, more diversified. You have higher capital ratios. You don't have the same fears around deposit flight. And there isn't a big question of unrealized losses in your security portfolios. So, over the medium term, we'd prefer to take the credit risk in these European banks. But considering the U.S. economy might be on better footing right now, the super regionals probably have a better chance of compressing closer to the U.S. money centers in the near term. Where we like to position now in Yankee banks is five years and in. Your spread curves are generally flat, and you're able to juice up the front-end carry-in credits where we don't have really any liquidity concerns. You can buy three-year senior European banks between 150 to 225 over treasuries. That would compare to BBB minus or even BB plus in an industrial. And we think that's an easy trade.

Michael: I think it's a really interesting discussion. And I sit here and wonder what the reaction would be in the U.S. if James, for example, presented a European bank with capital ratios under 10%, who didn't fully include all the AOCI losses in their capital ratio, but perhaps one for another day. And then just before we wrap up, I think it's also worth briefly touching on, especially within global funds that can invest across multiple currencies, how we go about deciding where we see the best value in a given name.

Chris: So, banks are a great vehicle in our global funds. They have large cap structures. They tend to be liquid. They issue frequently in dollars, euros, and sterling. We're able to take advantage of dislocations over time. After Russia invaded Ukraine last year, it was probably the first time in our recent memory where you could actually buy Barclays cheaper in euros than in dollars after adjusting for cross-currency. So, it's really important to have a collaborative approach across geographies. Our teams are in constant dialogue so that we can understand not only the relative trading relationships within each market but also the relationships across the three markets. But you certainly have to factor in the local sponsorship and the market perception into your analysis. You can't expect BNP to trade tighter than JP Morgan in the U.S. dollar market, for example. It's definitely more art than science.

Michael: Thanks, Chris. I think a really interesting discussion. James earlier helped detail why we continue to see the European banking system as resilient, despite the well-publicized likely headwinds, namely the expected deterioration asset quality as higher for longer interest rates start to impact the quality of loan book portfolios. We've previously set out the relative attractiveness of U.S. money center banks when compared to lower-rated industrials in the U.S. investment grade market. And we believe, despite Europe's weaker macro outlook, a similar argument can be made in the Euro-IG market as well. I really enjoyed Chris's insight touching on how we think about the relative value within the global banking industry, especially that between U.S. regionals and the large-cap European players. I anticipate that this debate will remain topical for a while as we continue to carefully monitor earnings, deposit, and asset quality trends, both sides of the Atlantic. With regards to positioning, we remain overweight European banks in a typical global corporate mandate. And in particular, like the front end, given the attractive carry and role on offer and comfort around fundamentals in the near term. It is also worth adding that for now, we see plenty of attractive opportunities in the large national champion banks in Europe and a little more cautious when it comes to smaller, more monoline, and concentrated players. So that's about all we have time for today. I would like to extend my sincerest thanks to my two guests, Chris and James. I appreciate you both joining me today and for your thoughtful input. And to our audience, thank you for lending us your attention on this latest episode of *All the Credit*®. I encourage you to check out the library of thought leadership and insights available on our website, www.PGIMFixedIncome.com. There you'll find all of our hard-hitting research, including more on the banking sector. And please be on the lookout for an upcoming banking blog from us as well, where we'll explore the issues, we've discussed in today's episode a little bit more broadly. Thank you again and look after yourselves.

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