Investment Strategy Note

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Banks – Too cheap to ignore or value trap?

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- **Banks have underperformed badly this year and last year. In fact banks are the only sector to be down both in 2015 and 2016 y-t-d (chart below)**
- **In actual fact, underperformance has been much longer-lasting than this, most banks' share prices still sit well below their 2008-09 crisis highs (chart below)**
- **The latest plunge in Deutsche Bank's share price begs the question "*when will banks performance finally turn around?*", or perhaps more pointedly, "*are bank stocks now too cheap to ignore?*"**
- **The short answer is; while the temptation to buy the sector is high given its underperformance, the time is not yet right. The reason for this is because the causes for bank share price weakness have yet to be resolved, we discuss the main 3 causes as we see them below**

A steeper yield curve, stronger economic growth or less regulation is needed to turn banks' performance around

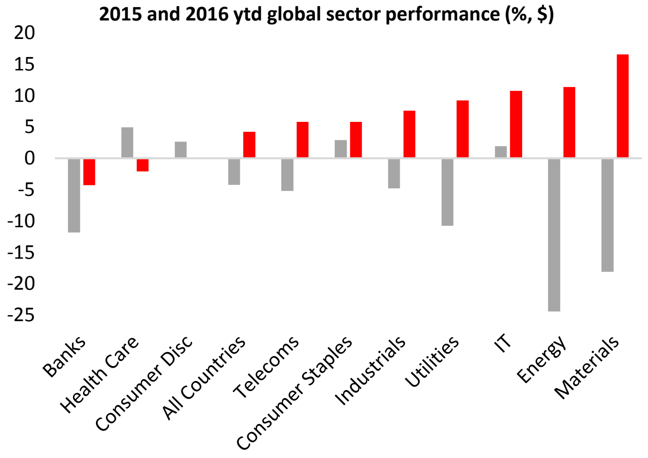
While there have been individual bank-specific factors which have contributed to banks' long-standing underperformance (such as at Deutsche Bank and Wells Fargo), the primary causes for weakness are:

- Central bank policy is causing banks pain
- Economic slowdown, banks are a proxies for economic activity
- Regulatory environment has changed for banks

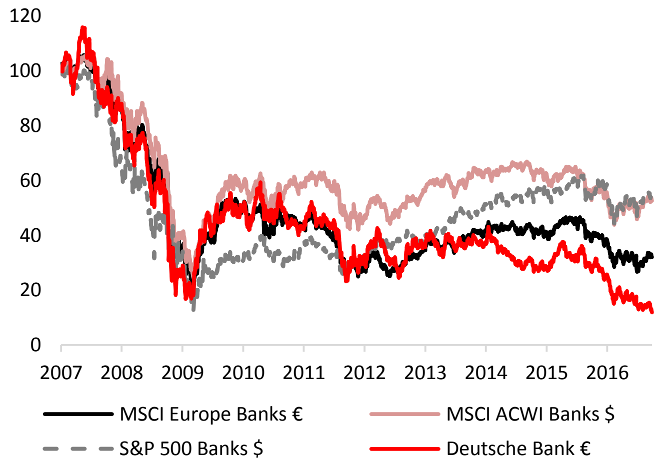
1) Central Banks unconventional monetary policy is hurting bank profitability

The threat of deflation has driven major central banks around the world to slash interest rates and buy-bonds (mostly longer dated ones). Investors have followed suit, flooding into longer-dated maturities in the hope of capital appreciation (more so than yields). With short yields theoretically limited as to how low they can go, and longer dated bond yields in many cases pushed towards zero or below, it has over time flattened the yield curve. Since it is banks' business model to borrow from short-term deposits and lend at longer-dated maturities it has had a major impact on banks' net interest margin, a key measure of bank profitability. The chart below shows the yield curves over time of the US, Germany and Japan (calculated as the yield differential between 10-year and 2-year bonds), the lower the differential the flatter the curve. Although the trend has been in place for many years, it has really accelerated over the past two years as the ECB has joined the QE-party and Japan has ratcheted up its easing measures (chart on next page).

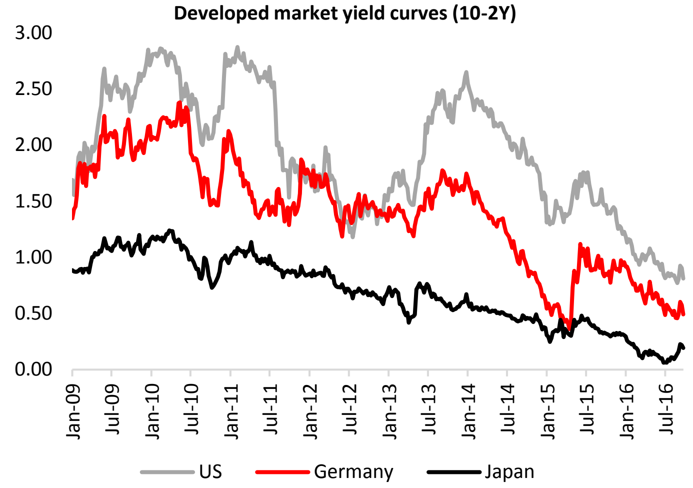
2015 and 2016 ytd global sector performance (%, $)



Bank shares have not recovered from the 2008-09 crisis



Source: Thomson Reuters



Source: Thomson Reuters

2) Economic slowdown, banks are proxies for economic activity.

Banks are exposed to everything, which makes them proxies for the health of the economy. If consumers are under pressure and need to deleverage, banks will be impacted. If energy prices fall sharply enough so that questions will be asked about the solvency of borrowers in the energy sector banks will also be impacted. If house prices fall banks again will bear the brunt. If financials markets conditions are generally weak this will weigh on returns that banks are able to generate from their wealth management or broking businesses. The fact that the global economic upswing post-2009 has been much weaker than is typically the case following a recession means that banks have been faced with a challenging environment.

3) Regulatory environment has changed for banks

Post the 2008-09 crisis governments around the globe have understandable made big efforts to curb the amount of risk that banks take on, nowhere more so than in Europe and the US. This has transformed banks operations, especially those banks with big investment banking and brokerage businesses. Not only that, but past-offences have been punished. Although total numbers differ depending on the source, the general consensus is that global banks have racked up fine in the region of $200bn since 2009 (up to the end of 2015).

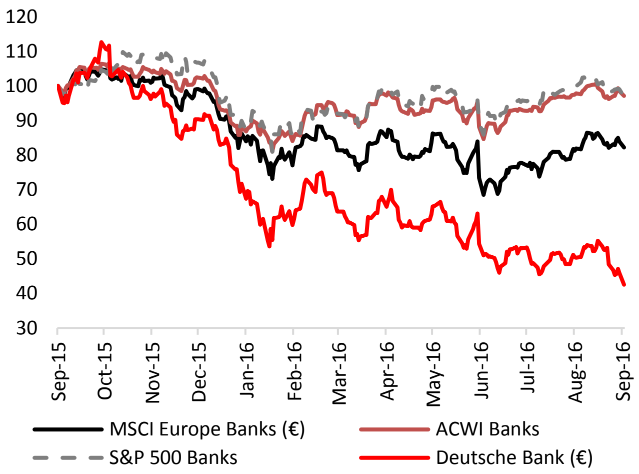
10 major banks fined since 2009 (up to end 2015)

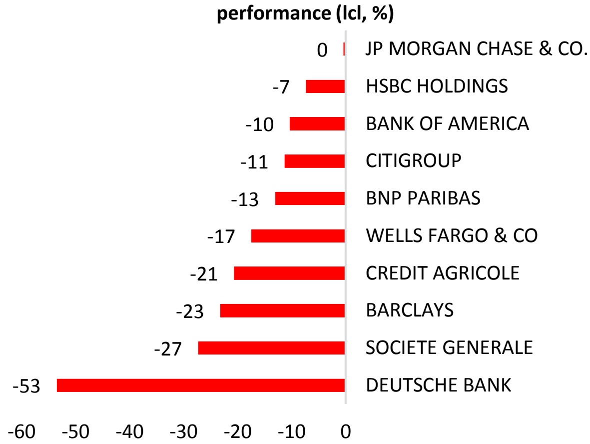
Company	Total settlments	Sums paid ($billions)
Bank of America	34	77.0
JPMorgan Chase	26	40.1
Citigroup	18	18.4
Wells Fargo	10	10.2
BNP Paribas	1	8.9
UBS	8	6.5
Deutsche Bank	4	5.5
Morgan Stanley	7	4.8
Barclays	7	4.2
Credit Suisse	4	3.7

Source: CNBC

Conclusion

Deutsche Bank's woes have made headlines, and the environment for banks is undoubtedly challenging. However, it is also important not to view the Deutsche Bank situation as a precursor for what is to come for the broader sector, the reality is likely that the situation is not as dire as Deutsche Bank's performance would suggest. Of course banks have performed very poorly, in line with the energy sector since the start of 2015. And while energy sector performance has rebounded in 2016, banks are the only sector to be down both in 2015 and 2016 y-t-d and substantially more since the 2008-09 crisis. This considerable underperformance has put banks on the radar screen of value investors around the world. **The temptation to buy the sector at depressed levels is therefore understandable, but in order to turn more positive on global banking stocks we believe mere underperformance of the sector is insufficient reason.** Unless there is a central bank induced change which leads to steeper yield curves or a substantial improvement in economic growth prospects (the former is more likely we think) it will be difficult to view a rally in bank share prices as anything other than a dead cat bounce. Longer-term, regulation changes mean that a return to pre-2008 profit levels is unlikely, however, there will come a time when banks offer a very attractive risk-reward trade-off. We do not believe that we are there quite yet and recommend investors focus on defensive sectors such as telecoms, consumer staples, health care and utilities instead. Of course we will monitor the situation carefully for changes to these key drivers for bank performance.





Source: Thomson Reuters

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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