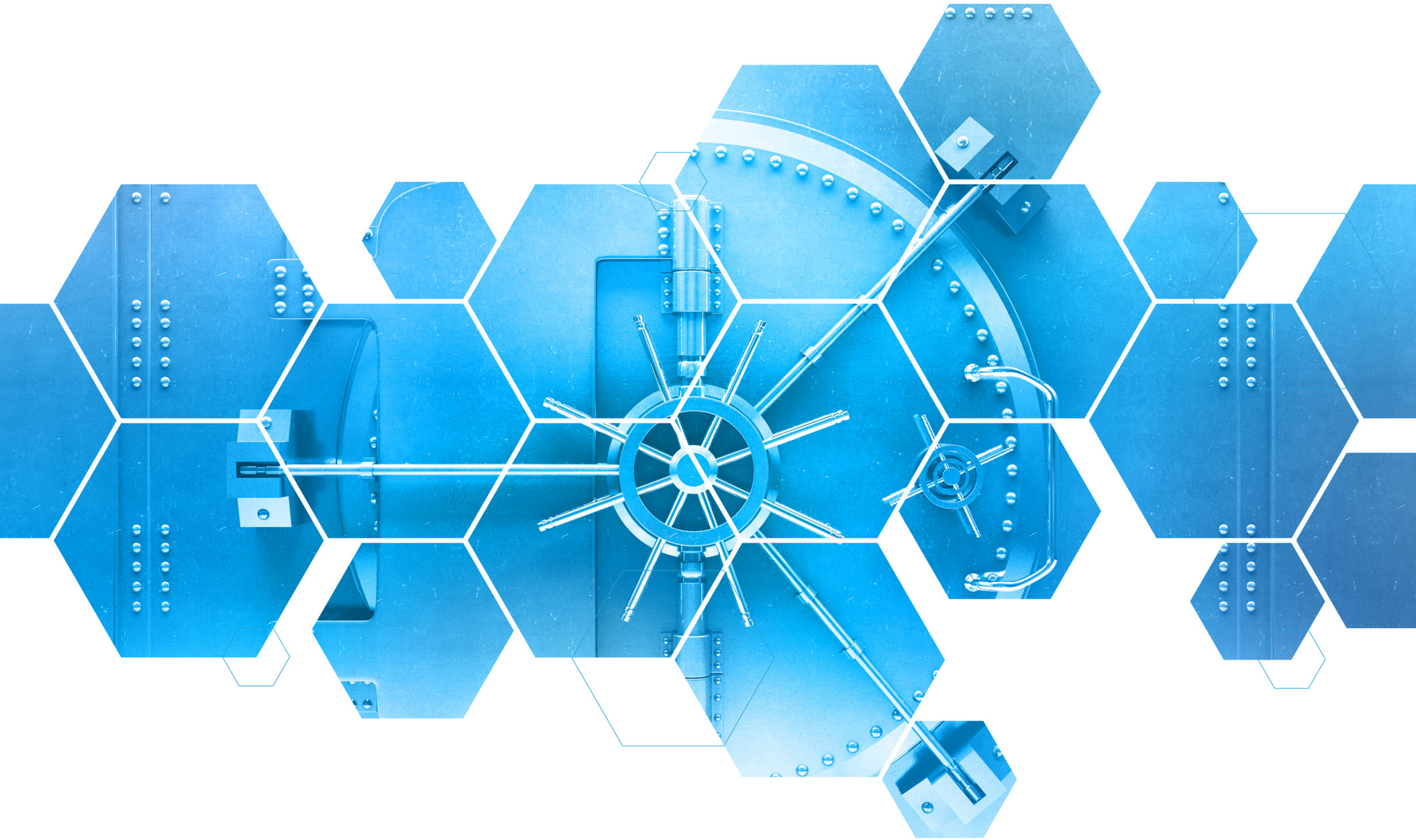
Polar Capital Global Financials Team

Banks and COVID-19

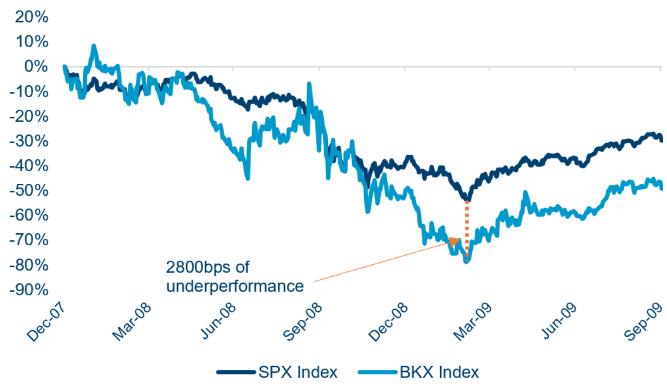


Banks during COVID-19: A crisis of sentiment, not balance sheet

2020 has not been an easy year for bank investors, either relative to overall markets or other subsectors within the financial sector. As shown below, US banks have underperformed the broader market by 40% year to date, (even excluding tech the banks have underperformed a lot), a performance gap that is significantly wider than the lows of the global financial crisis (GFC) in March 2009.

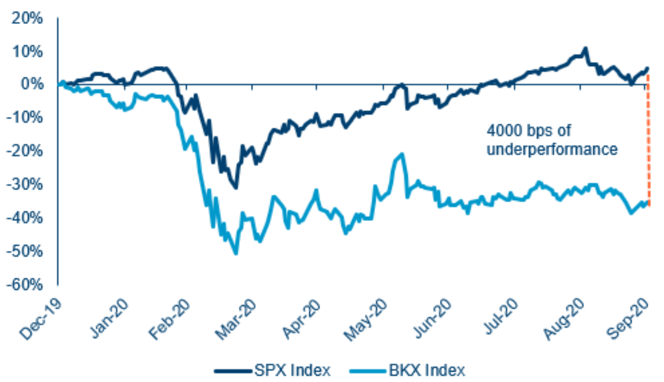
European banks have been even greater laggards and are trading at record low valuations in terms of relative P/E versus the market, a 53% discount versus a long-term average of 27%, and at 0.4x price/book (P/B). To give some context on the relative weakness of banks in Europe, the market cap of eurozone banks is 38% of Australia and Canada's banking sectors combined yet the eurozone GDP is nearly six times their size. Within Europe, UK banks have been in the eye of the storm, affected by political risk, in relation to both Brexit and US/Chinese tensions, as well as economic uncertainty related to COVID-19, and have fallen 50% YTD, underperforming their European peers. HSBC is now trading at a lower P/B multiple than in both the global and Asian financial crises.

Chart 1: S&P 500 vs KBW Bank Index in 2008/2009



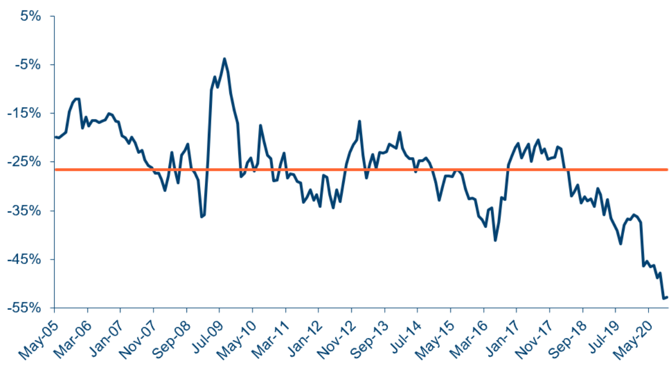
Source: Bloomberg, October 2020

Chart 2: S&P 500 vs KBW Bank Index in 2020



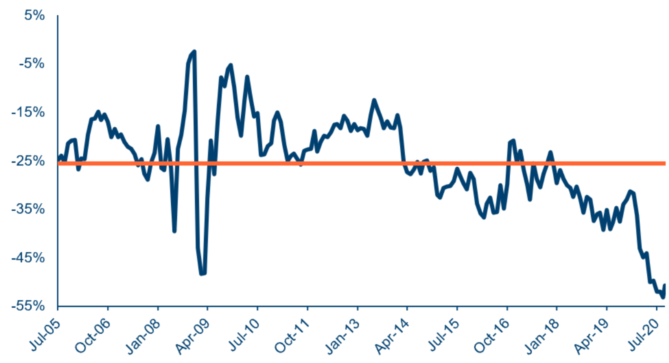
Source: Bloomberg, October 2020

Chart 3: European Banks Relative P/E vs Market - 2022 EPS



Source: Bloomberg 13th October, 2020

Chart 4: US Banks Relative P/E vs Market



Source: Bloomberg 14th October, 2020

The myriad of different issues potentially driving these concerns include lower rates forever, fears over the asset quality outlook, last crisis memories, dividend restrictions, fintech challengers, political risk ahead of the US election, Brexit and so on. Frighteningly, the list is long for investors like us, but the issue is how valid they are.

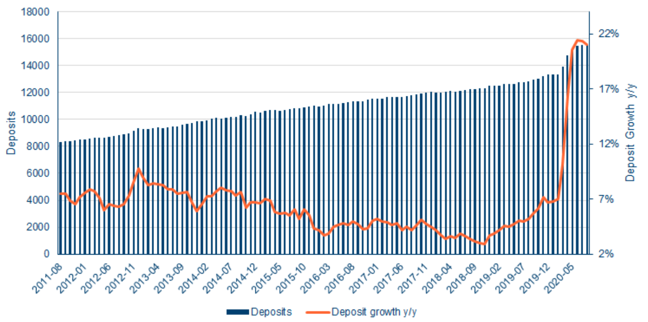
Here, we will focus on the issue of bank balance sheets and fears over a potential asset quality crisis. In a subsequent commentary, we will look at whether the current environment has weakened their structural positioning and long-term profitability.

Liquidity surplus not deficit

Banks usually fail because of a liquidity crisis, as per Lehman Brothers, which results in a crisis of confidence in the overall sector and is often seen through other players cancelling their lines of funding or retail depositors pulling out their savings, as per Northern Rock. This time around, government support for jobs and companies coupled with central bank liquidity provisions resulted in large deposit inflows. Some of this is because companies pre-emptively made use of their lines of credit to preserve liquidity, a trend seen clearly in the US, Europe and UK.

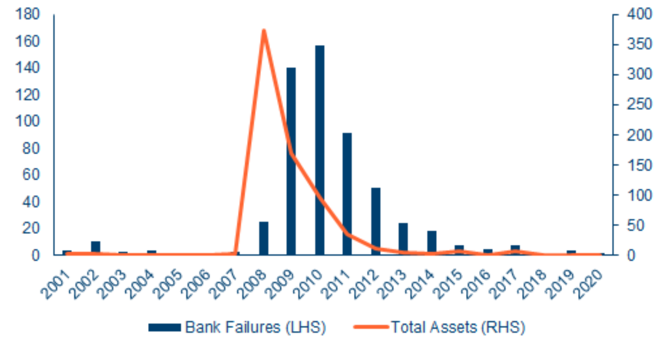
Even in emerging markets we have not seen the usual pressures on funding and, overall, there have been few bank failures. In fact, one of the problems for banks has been the surplus of deposits having to be placed in low earning, non-loan assets which has further exacerbated the pressure on their margins. Ultimately, falling margins because of high levels of low-risk/low-earning assets is less of a concern from our perspective than structural falls in margins. Regulatory measures taken after the GFC have helped by ensuring bank balance sheets have sufficient liquidity. However, depositors, particularly corporate depositors, have been more than happy to deposit their savings with the banks when compared to GFC (see below).

Chart 5: Bank deposit growth 2008-09 vs 2019-20



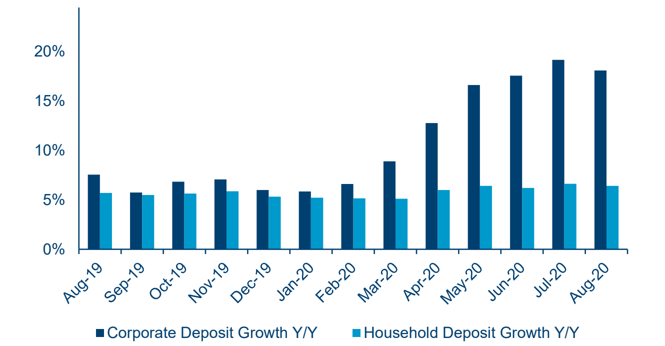
Source: US Federal Reserve, October 2020

Chart 6: FDIC - US Bank Failures



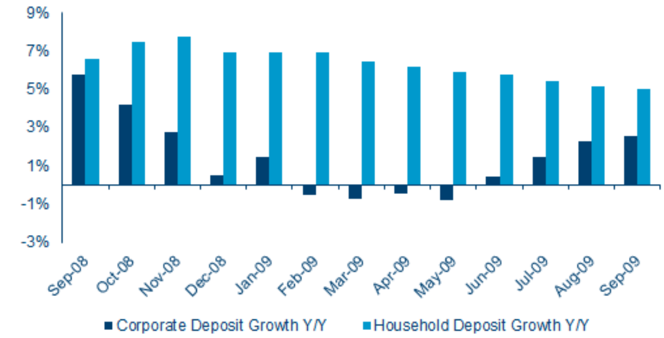
Source: FDIC, October 2020

Chart 7: 2020 Covid Crisis - Euro Area Deposit Growth Y/Y



Source: ECB, October 2020

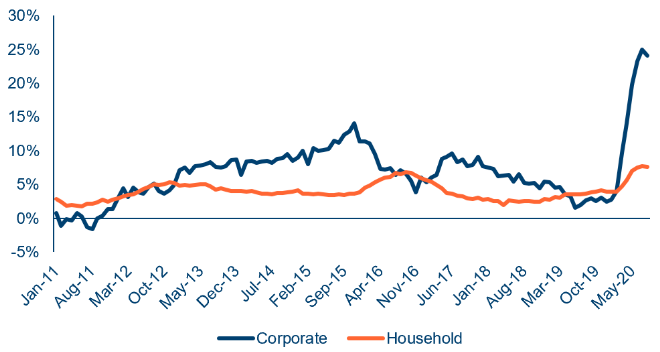
Chart 8: GFC Crisis - Euro Area Deposit Growth Y/Y



Source: ECB, October 2020

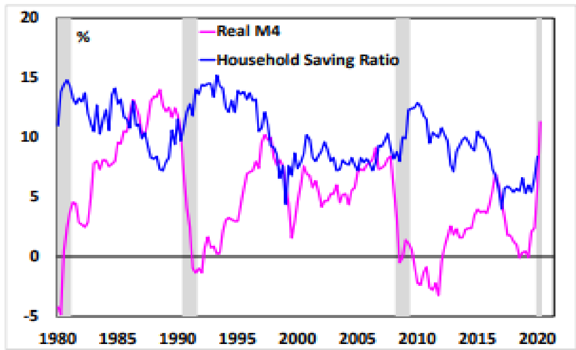
A key difference with previous crises is that broad money growth has increased despite a pick-up in the household savings ratio (in both the 1990s and 2008-09 downturn, real M4 contracted). While households have deferred spending due to restrictions, and economic uncertainty, there has been material growth in corporate loans driven by government stimulus measures through state-guaranteed lending schemes. We have used UK figures in the charts below but there are similar trends in broad money growth in the US, Europe, Australia and Japan. The banking sector has ample liquidity and capital to facilitate government support and in marked contrast to the situation last cycle, the stimulus measures are leading to a material increase in broad money growth.

Chart 9: UK - Y/Y Growth of Broad Money, M4



Source: Bank of England, October 2020

Chart 10: UK Real M4 vs Household Saving Ratio



Source: Bank of England, October 2020

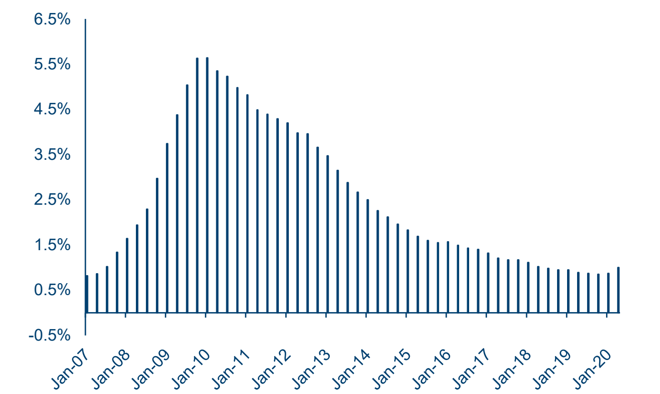
Loan books have been resilient

The second key reason banks fail is that their loan book quality deteriorates to the extent their capital is wiped out and they have to be recapitalised. It is not only loan books which can cause problems since other investment bond-type instruments can collapse, although this is more of an issue for the investment banks than most of our commercial bank holdings.

We suspect this is the principal reason for the underperformance of the sector since the weak macro environment would imply an avalanche of problems and yet, to date, this has not materialised. As shown below, non-performing loans for banks have been rising but hardly at an exponential rate – they remain low by historic standards and when compared to the GFC.

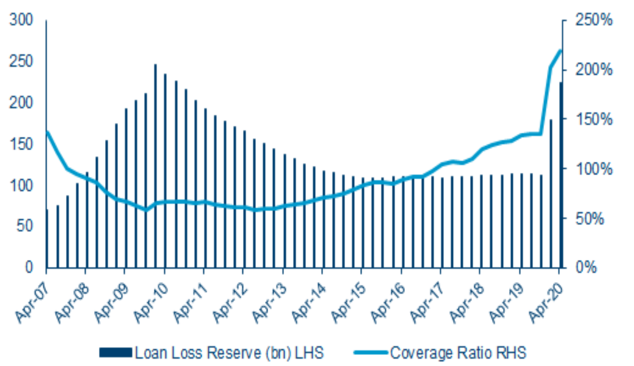
However, banks, particularly those in the US, have been sharply increasing their provisioning for problem loans (see the chart below). Some of this relates to worries about the future but more important is the introduction of the IFRS9 accounting standard (CECL in the US) which requires banks to make pre-emptive provisions. Therefore, banks are being much more cautious than in previous crises.

Chart 11: US NPL Ratio



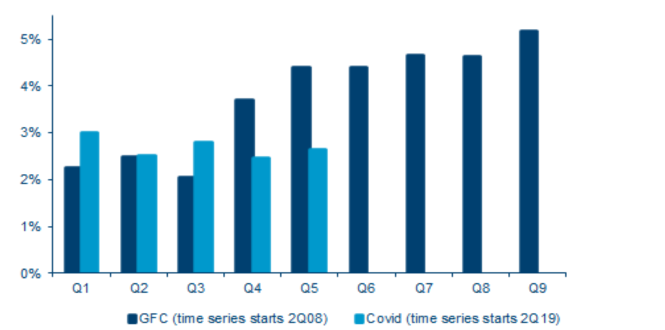
Source: Federal Reserve Bank of St Louis, October 2020

Chart 12: US Bank LLR & Coverage Ratio



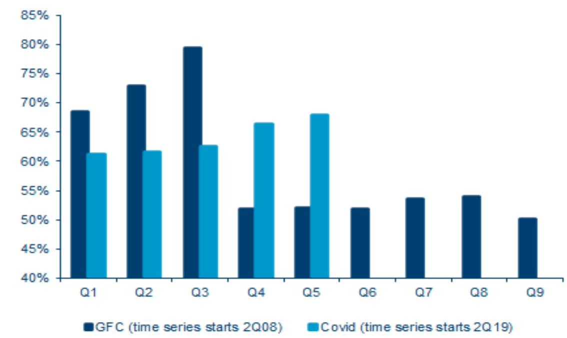
Source: Federal Reserve Bank of St Louis, October 2020

Chart 13: GFC vs Covid Crisis: European Bank NPL Trends



Source: Barclays, October 2020

Chart 14: GFC vs Covid Crisis: European Bank NPL Coverage Trends



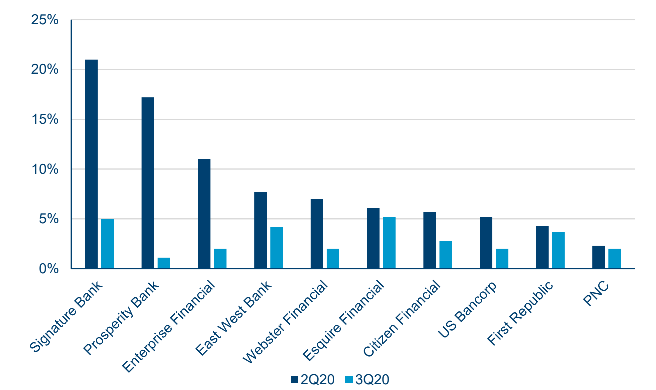
Source: Barclays, October 2020

If banks are making large pre-emptive provisions on non-performing loans, why are share prices so weak? (see the charts below which highlight the concern). Earlier this year, we saw large levels of loans under deferral (we have used examples of some US mid-cap banks) and the assumption was that these would eventually migrate into non-performing loans. To date, however, the evidence has been encouraging and early indications from Q3 results have been positive, with JP Morgan reporting a significant fall in consumer loans under deferral (3.4% of total consumer loans compared to 7.9% in 2Q20) and noting 92% of the accounts that have exited deferrals have reverted to performing loans. Bank of America reported a 75% fall in consumer loans under deferral, to 2% of total consumer loans (of which 75% relates to mortgages with low loans to value – LTVs).

This was not just a US phenomenon, since governments globally intervened to ensure banks allowed deferrals – we have also included data below on some of our European and Indian holdings. Data on European deferral trends post Q2 results have consistently shown the large majority have reverted to repayment following the expiration of the moratorium period and that arrears levels have remained low. Consequently, while the outlook remains uncertain, data on deferral trends has been a contributing factor in managements guiding for a peak in provisioning in 1H20. Lloyds Bank noted in September that nearly all deferral loans have rolled off with very low arrears, 80% reverting to normal repayment while 20% have secured an extension. OneSavings Bank saw a material fall in loans under deferral (falling to 5.8% from 28% in June) while Caixabank noted that only 3% of loans under deferral had missed payments, either totally or partially, which had given them confidence in their 2020 provisioning guidance (peak in 1H20; meaningful reduction in FY21). HDFC Bank noted its collection efficiency had already reached 95% in its retail book and is expected to be 97% next month.

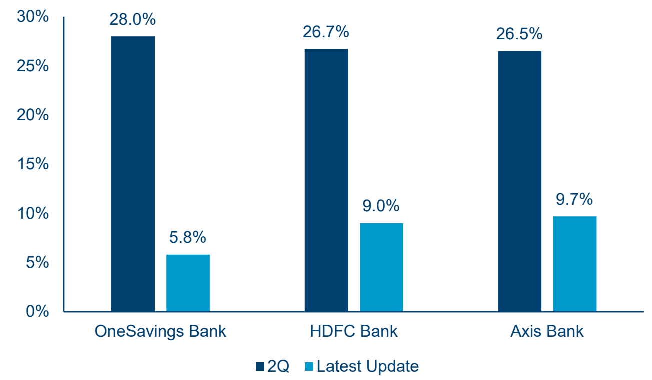
What is also clear from these charts is that many of these loans did not migrate into non-performing loans and yet share prices remain in the doldrums.

Chart 15: US regional bank holdings: loans under deferral trend



Source: Polar Capital, company filings; October 2020

Chart 16: Loan Deferrals - Quarterly Trend



Source: Polar Capital, Company Filings, October 2020

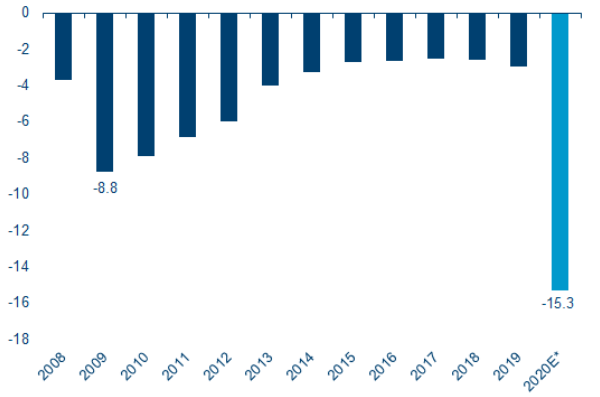
Why has the environment been so benign for bank loan-book quality? The starting point is that governments have stepped in to support economies through fiscal support, including spending on wages and guaranteed corporate loans among some of their measures. Governments have reacted to this downturn with unparalleled speed and scale and the nature of the health crisis has galvanised leaders to respond with significantly larger fiscal stimulus than seen in the GFC.

Direct fiscal support has come in the form of cash payments (the US CARES Act included $1,200 payments per adult and $500 per child as part of the $2trn stimulus package) and furlough schemes to subsidise employee salaries (between 60% and 100% of wages covered through government grants). There has also been significant support provided through state-guaranteed lending schemes, including the Paycheck Protection Program in the US, CBILS in the UK and SFGS in Hong Kong, which have accounted for the large majority of corporate lending during this period.

The structure of the loan programmes varies but, in general, the loans are targeted at small and medium-size businesses, come with interest payment holidays, subsidised loan rates and are backed by a high level of government guarantee. While loan rates are lower, given capital relief and government guarantees, this offers the potential for profitable new lending, with some estimates suggesting a 17%-61% RoE range. To give some context on the scale of stimulus, the US deficit at 15% of GDP is the largest since World War II, while the Fed's balance sheet is set to expand more than QE 1, 2 and 3 combined.

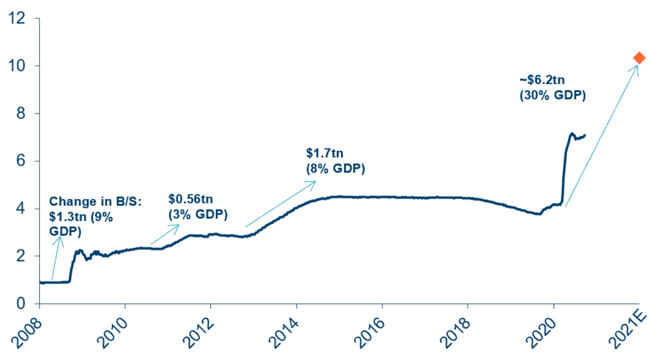
These measures have provided rapid liquidity to the economy and preserved employment, reflected in resilient asset quality data, but clearly there are questions as to the extent to which businesses will suffer and employment levels fall once government stimulus fades. The combination of jobs saved, monetary support (ie low interest rates) and COVID-19 restrictions placing a stop on consumer spending has meant individual leverage has come down, as shown below, which is only positive for servicing debts.

Chart 17: G4 General Government Fiscal Balance (% of GDP)



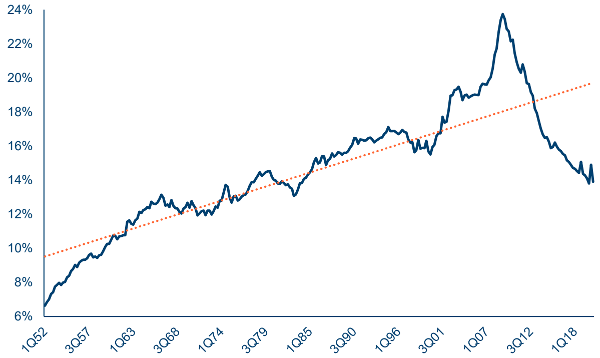
Source: Haver Analytics, CEIC, IMF, national sources, Morgan Stanley Research forecasts; Note: G4 aggregate is the PPP-based GDP weighted average.

Chart 18: Federal Reserve Balance Sheet (USD tn)



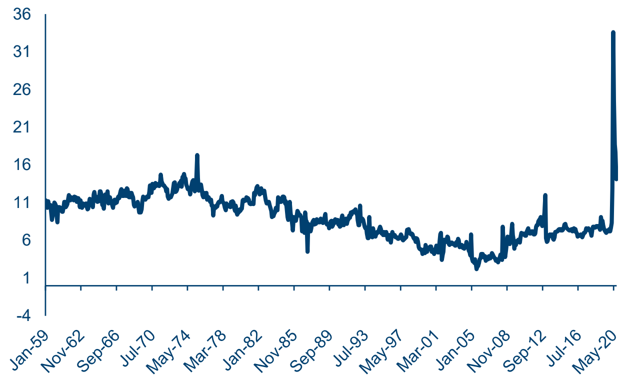
Source: Federal Reserve Board, Federal Reserve Bank of New York, Morgan Stanley Research forecasts

Chart 19: US Household Leverage



Source: Federal Reserve

Chart 20: US Personal Savings Rate

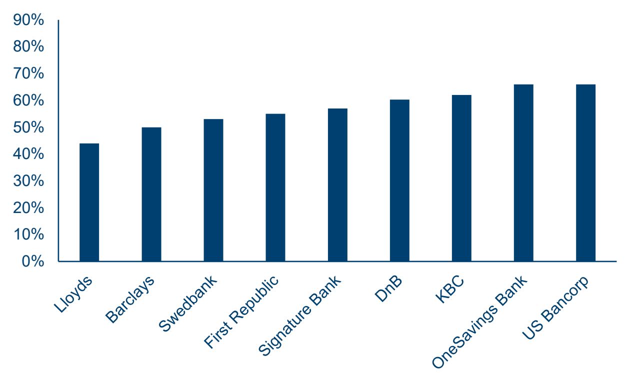


Source: Federal Reserve Bank of St. Louis, October 2020

Even real estate, a traditional source of bank asset quality problems, has held up remarkably well (banks continue to assume price falls in their models when calculating their loan loss provision assumptions). Despite the economic dislocation from the pandemic, house prices across the regions have held up well, supported by co-ordinated monetary and fiscal stimuli which have resulted in lower interest rates and supported employment levels. The US approach of direct fiscal transfer through cheques to citizens, rather than furlough schemes, explains the divergence in unemployment trends compared to the UK and the eurozone.

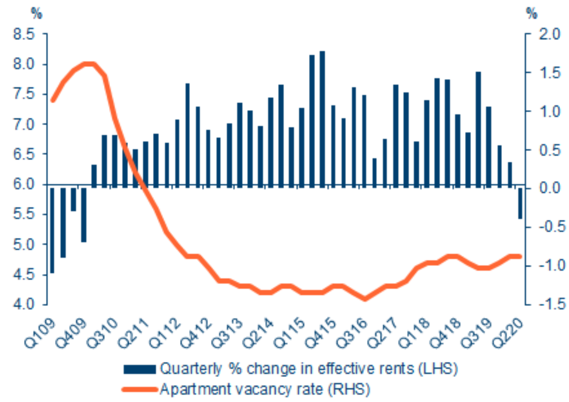
There have been some small declines year to date in certain US cities (New York -2%, San Francisco -1%) but, in general, US house price trends have been stable or have expanded while the latest data for the UK and eurozone showed a 5% rise y/y. Alongside the government stimulus measures, recent house price figures have reflected pent-up demand following the lockdown while in the UK a temporary reduction in stamp duty has also supported the market. Housing markets have therefore benefited from further government intervention and temporary factors which are set to fade but, from the banks' perspective, risk is mitigated by low LTVs as well as limited loan growth ahead of the downturn. The credit/GDP Gap is a key early warning indicator of future bank losses and the graph below highlights the marked contrast in risk appetite ahead of this downturn with the previous two recessions in the UK and US.

Chart 21: US & European Bank Loan-To-Value Ratios



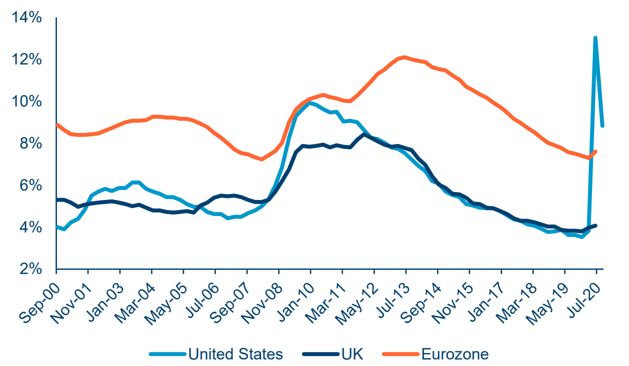
Source: Polar Capital, Company Filings, October 2020

Chart 22: US Vacancy Rates and Rental Prices



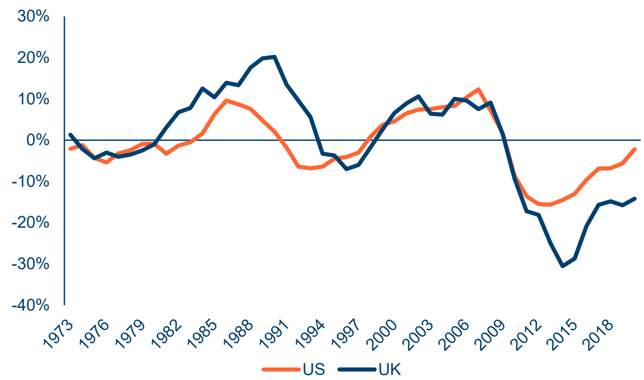
Source: Polar Capital, Company Filings, October 2020

Chart 23: US, UK & Eurozone Unemployment %



Source: Federal Reserve Bank of St. Louis, Bank of England, ECB, October 2020

Chart 24: US & UK Credit - GDP Gap



Source: Bank of International Settlements, October 2020

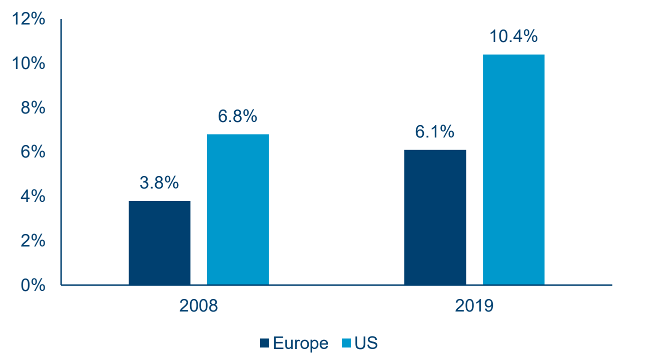
The worry is that all this good data is about to take a turn for the worse as COVID-19 restrictions remain in place, governments pull back on some of their original measures. US bank managements in the recent Q3 results highlighted that while uncertainty remains as to eventual losses they are comfortable with their reserve level that incorporates further deterioration in unemployment. Jamie Dimon, CEO of JP Morgan, stated the bank estimates it is over-reserved by $10bn should the Fed's base case scenario play out.

With banks tightening lending standards, there is a risk of a credit crunch once government loan schemes expire. However, we think it is unlikely that governments allow a sharp contraction in liquidity through a withdrawal of stimulus measures during a period of heightened uncertainty. This was highlighted by the recent extension of the UK Job Support Scheme and the additional fiscal stimulus announced by France and Germany (EUR20bn & EUR10bn respectively) in relation to the second lockdowns implemented in November. Data on deferral trends is a key indicator of the potential impact on the sector as borrowers transition out of government support schemes. The latest data on deferrals has been encouraging, with the large majority of borrowers reverting to repayment suggesting the sharp rise in government transfers has enabled businesses to weather the extraordinary period of economic lockdown. In contrast to the situation during the GFC, banks have been able to utilise strong capital and liquidity positions to meet the higher credit demand associated with government-guaranteed lending and consequently have been a key part of governments' solutions to the health crisis.

Capital remains strong

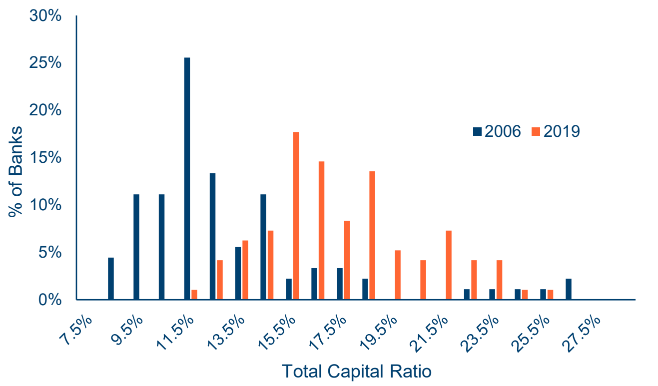
A key difference with the GFC is that capital is materially higher than it was prior to that crisis, driven by regulatory requirements as well as years of relatively low rates of loan growth. Little loan growth and dividend/buyback restrictions will enable banks to generate capital internally and we would argue the blanket ban on dividends will be reassessed sooner than many investors expect.

Chart 25: Equity/Assets



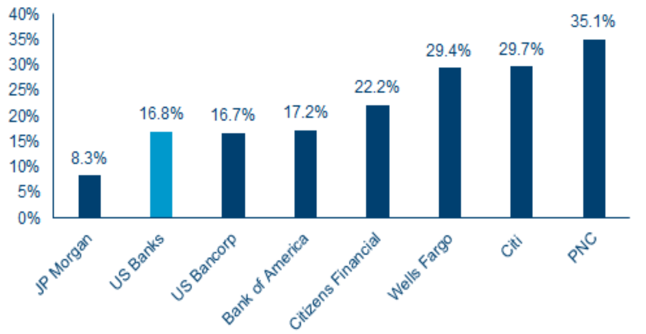
Source: Polar Capital, Company Annual Reports

Chart 26: Total Capital Ratio of Major International Banks



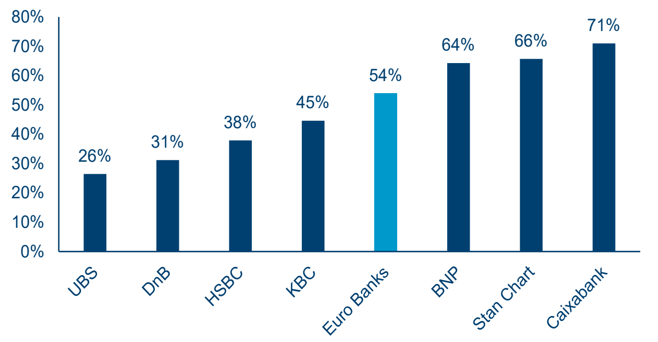
Source: Various[1]

Chart 27: US Banks Excess Capital / Market Cap



Source: Polar Capital, Company Filings, KBW, Barclays

Chart 28: European Banks Excess Capital / Market Cap



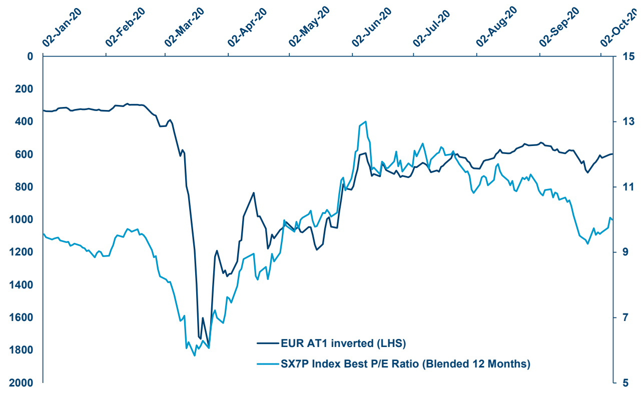
Source: Polar Capital, Company Filings, KBW, Barclays

It is important to highlight that, although buybacks have been suspended, US banks have continued to pay a dividend through the pandemic while the ECB and BoE have placed a blanket ban on capital return. Recent comments by the ECB have emphasised the ban is temporary and they wish to return to a normalised framework on a bank-by-bank basis where they only intervene on the distribution of dividends for weaker banks. With macro data beating initial projections, as well as asset quality and capital trends, there is a possibility the ban will be lifted at the ECB review in December. We accept, however, that much will depend on the development of the health crisis and that the environment remains uncertain. Given a sustained period of balance sheet strengthening with capital build supported by low levels of loan growth (average annualised loan growth in the past three years of 2.8% and 2.3% respectively for US and European large-cap banks), the sector is in a position to return a material amount of capital once restrictions are lifted. While the exact timing of regulatory easing is unknown, we expect it to prove a strong catalyst for recovery given the material surplus capital positions, shown on the graphs above.

Ultimately, you do not have to take our word for bank balance sheets being in reasonable shape. The table below highlights what the credit market believes and is materially more positive than the equity market.

1. Source: I Aldasoro, I Fender, B Hardy and N Tarashev, "Effects of Covid-19 on the banking sector: the market's assessment", BIS Bulletin, no 12, May 2020; U Lewrick, C Schmieder, J Sobrun and E Takáts, "Releasing bank buffers to cushion the crisis – a quantitative assessment", BIS Bulletin, no 11, May 2020; FitchConnect; BIS calculations.

Chart 29: Europe AT1 Spreads vs European Bank P/E Ratios



Source: Bloomberg, October 2020

We believe all this would imply that banks are undervalued and our exposure to the banking sector has been gradually rising in the Polar Capital Financials Trust and the Polar Capital Financial Opportunities Fund in recent months.

Polar Capital Global Financials Team

27 October 2020

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