Sector review: European Banking

November 2020

European banks began the crisis in a position of relative strength, and many still look adequately prepared for extended uncertainty. Relative valuations appear to present some interesting opportunities.

The European banking sector entered the crisis with balance sheets in a relatively strong position compared to prior recessions. Nevertheless, with renewed lockdowns across Europe, our sector outlook remains declining, reflecting the expected impact of Covid-19 on earnings and asset quality. We are almost at the end of third-quarter earnings, which have so far brought largely positive news. Capital has improved, with an average increase in common equity tier 1 ratios of 40 basis points (bps) quarter on quarter; however, we expect this to be something of a high watermark, with capital likely to move lower as negative credit migration starts to materialise. Net profits are up and continue to beat, or come closely in line with, consensus expectations, driven primarily by beats on provisions, while revenues and costs have looked pretty resilient.

As with the US, European capital markets trends for investment banks have been strong this quarter. Provisions are still elevated, but have largely beat expectations and look on track to be in line with the 'second half lower than first half' guidance of mid-year, assuming there is no deterioration in macro assumptions. At this stage, we still expect average provisions for 2020 for our universe to increase 3-3.5x in our base case, with some banks seemingly having frontloaded more than others. Asset quality hasn't seen any material deterioration, with non-performing loan ratios largely stable. Credit migration is mostly only expected from the first half of 2021 onwards as government programmes and moratoria run out. However, it should be noted that payment deferrals have been declining significantly and have been mostly performing. We expect M&A to remain focused on in-market consolidation (mostly in Spain/Italy) in the near term.

Looking forward

Detailed macroeconomic assumptions have been released alongside bank earnings guidance in 2020. Most European banks assume something close to a V-shaped economic recovery as their base case. If this scenario holds, the first half of 2021 should represent the peak of provisioning and we would expect banks in our coverage to be able to manage the asset quality deterioration given the strong balance sheets coming into the crisis, bolstered by the regulatory forbearance measures.

As for many sectors, elevated uncertainty related to the pandemic timetable remains a key risk. With most of Europe currently undergoing the second wave and lockdown measures extended, we might expect banks with lower profitability and/or lower capital buffers to come under the most pressure in the near future. In the downside scenario of extended lockdowns with accompanying severe macro impacts (double-dip recessions), we would expect ratings downgrades across the board, as well as the potential for the suspension of coupons on select additional tier 1 contingent convertible (CoCo) bonds.

AUTHOR

Jasmin Manetta,
Research Analyst, Global Fixed Income, Currency & Commodities (GFICC) group

Investment opportunities

In light of elevated levels of uncertainty, we have conducted extensive stress tests on European financials to help inform our views. The results of the stress tests, which factored in highly conservative and severe assumptions, suggested that many banks within the sector have adequate capital buffers to withstand a prolonged economic downturn. We believe banks are well positioned to weather this most recent downturn, supported by robust liquidity, resilient capital under severe stress scenarios, and the expectation that realised credit losses will remain muted in the remainder of the 2020.

While the fundamentals remain robust, the relative valuations on offer within the banking sector provide an attractive opportunity for investors. Globally, over $15 trillion of debt is trading with a negative yield as of October 2020 and therefore the valuations on offer within credit markets broadly and European banking in particular look relatively attractive. European CoCos are trading with an option-adjusted spread (OAS) of 404 bps, while we also see opportunities further up the capital structure, such as European Tier-2 bank capital, which offers an OAS of 143 bps. We take a selective approach in these more junior parts of the capital structure, informed by the results of our stress testing and our views on the fundamental resilience of the banks.

Overall, while the sector faces risks around the length of this second wave and of the current economic shutdowns across Europe, the relative strength of the sector, combined with the relative attractiveness of the valuations, means that European banks remains one of our highest conviction ideas heading into end of 2020.

NEXT STEPS

For more information, contact your J.P. Morgan representative.