RBC BlueBay
Asset Management

Reinstated confidence: Bank fundamentals, quality and profitability

For professional investors only | Marketing communication

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Investment grade financials specialist Marc Stacey delves into why the current market environment should be beneficial for banks.

Key points:

- The gradual recovery of banks since the Global Financial Crisis means they are more robust and profitable today.
- The regulatory framework and monetary policy have each played their part.
- Even if asset quality starts to deteriorate, an improved earnings environment should give investors increased confidence.

> "Within the broader financials sector, the banking sector has reestablished strong financial fundamentals partially due to enhanced regulatory oversight."

One thing that's clear from studying the financial sector is that it is remarkably resilient. The period from 2009 onwards saw balance sheets rebuilt, business models repurposed and increased regulatory reform, and these measures have contributed to stronger fundamentals and the sector's profitability.

Within the broader financials sector, the banking sector has reestablished strong financial fundamentals partially due to enhanced regulatory oversight. The framework regulation Basel III forced management to change the way banks are run, and now they are more focused on net interest margin, advisory, and brokerage. And as a result, banks are incredibly robust because liquidity and capital are near their highs. Regulatory enforced change is here to stay. Banks are back to playing the role of being a transmission mechanism into the real economy. In our view, should a global slowdown occur, strengthened balance sheets and higher capital levels should mean banks are far more capable of weathering a potential storm.

While the regulatory framework has played a significant role, so has monetary policy. The ECB's rate hikes of over 400bps over the last few years have gone a long way towards enhancing profitability. At the end of 2023, European bank profitability was up significantly from 2020. The current environment is very positive for banks. Even if rates do start to come down, banks have hedged themselves, so we expect their profitability to remain resilient for the next two or three years. Therefore, while capital levels are one of the fundamental reasons why we liked this sector, we now have another – profitability.

Some investors may fear that we start to see defaults pick up or see asset quality start to deteriorate. However, we haven't seen this yet because unemployment is still at historic lows and people are servicing their loans.

"We believe that the banking sector is attractive today and has the resilience to weather an economic recession should there be one."

For unemployment to be a real problem, it would need to pick up for a relatively prolonged period. That's when you would see discretionary spending go down meaningfully. And once that's been exhausted, that's when asset quality would really start to deteriorate. But people have been fearing a deterioration in asset quality for a whilenow, and if anything, asset quality has recently been improving.

In summary, we believe that the banking sector is attractive today and has the resilience to weather an economic recession should there be one.

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