RBC BlueBay Asset Management

Elevated rates: Now is the time to consider the banking sector

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"Today banks and financials are no longer viewed as the problem they were during the global financial crisis."

Investment grade financials specialist Marc Stacey, BlueBay Senior Portfolio Manager, delves into why identifying 'national champion' investment grade issues in developed markets is a smart decision.

Banking sector resilience

Following the Global Financial Crisis ("GFC"), regulators have spent over a decade rebuilding bank balance sheets and repurposing their business models. Creating a sector with record levels of capital and well-governed management teams. Making banks significantly more resilient than pre-GFC.

Today banks and financials are no longer viewed as the problem they were during the global financial crisis but rather as the primary transmission mechanism for financial policy to reach the real economy.

Furthermore, banks continue to benefit from huge tailwinds of higher rates, with profitability soaring over the last few years. European profitability is up circa 70% from 2020 as at the end of 2023[1].

The result is that banks today are far more robust and profitable than they have been for the last decade. In our view, should a future crisis or global slowdown occur, their strengthened balance sheets and higher capital levels should mean they are far more capable of weathering any potential storm.

In this context we believe that bank debt remains undervalued and provides attractive opportunities for capital appreciation over and above the strong carry component.

[1] Source: Fixed Income Specialisms | RBC BlueBay Asset Management.

What does this mean for investors?

The sector faced several headwinds in 2023. US regional banks were hugely challenged given the large mark to market losses from government bond yields repricing higher. Across the pond, in Europe, a household name that was globally significant effectively went bust over the course of a weekend. All of which understandably rattled the market. Hence why, despite strong sector fundamentals, spreads are as wide as they are today, and why yields are as attractive as they are.

Add to this to the backdrop of higher rates, which banks should thrive in. Even factoring the rate cuts expected by the market, which we think are overly optimistic given the still high core inflation prints, profitability at banks should be circa 50% higher than in 2020[2].

If we see asset quality start to deteriorate and the cost of risk move higher towards the cyclical average of 50bps per year, this would barely dent the profits being generated.

Even when we model an extreme stress scenario with the worst cost of risk that has been witnessed over the last 10-15 years, which is a cost of risk of 400bps (akin to what was experienced during the GFC), the bulk of the profitability is eroded, as one would expect, but there is little to no impact on the vast amount of regulatory capital that has been built up over the last 15 years, a capital buffer which should be large enough to absorb any macro or idiosyncratic risks which emerge. This makes an investment into subordinated bonds, especially AT1 securities, particularly interesting given the elevated yields on offer.

We believe all of this means that the fundamental resilience of banks is not being reflected in valuations, and we are confident this should correct over time. Leaving open a highly opportune entry point for investors willing to gain an exposure to this space.

[2] Source: Fixed Income Specialisms | RBC BlueBay Asset Management.

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