Private Bank

European banks – economic tailwind

BARCLAYS

Overview
– The European economy continues to provide a helpful backdrop for the region's banks
– Valuations are not demanding, providing room for re-rating
– Regulatory and other risks remain, but upside potential remains significant

Value or value trap?

Value shoppers have long eyed up the continental European banking sector. Whilst the same sector has soared at the other side of the pond, shares in Europe's banks have mostly languished. Cost efficiency, non-performing loans and negative interest rates are just some of the factors which have weighed on banks' profitability. However, with the European economy showing signs of a healthy revival, the fundamental outlook for European banks is likely to improve from here, in our opinion.

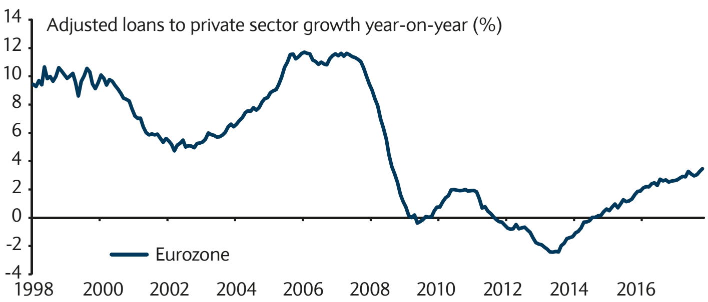
Cyclical tailwinds

With the ECB in no hurry to raise rates, we are reliant on Europe's cyclical upturn, rather than higher net interest margins, to drive bank profitability higher. As domestic growth stabilises, evidence trickles in of increased demand across corporate lending, mortgages and consumer credit. A robust macro backdrop should continue acting as a tailwind for loan growth – a key driver of bank profitability (Figure 1). Alongside this, the weight of non-performing loans, so long a burden on profitability, capital requirements and the ability to lend, should continue to lighten amidst this improved economic backdrop. Meanwhile, banks' capital positions have significantly improved in recent years, with the European sector's core regulatory capital as a proportion of total risk-weighted assets having doubled in the last decade. On balance, European banks have been moving in the right direction, and their fundamental position has improved markedly compared to the last several years.

Take out

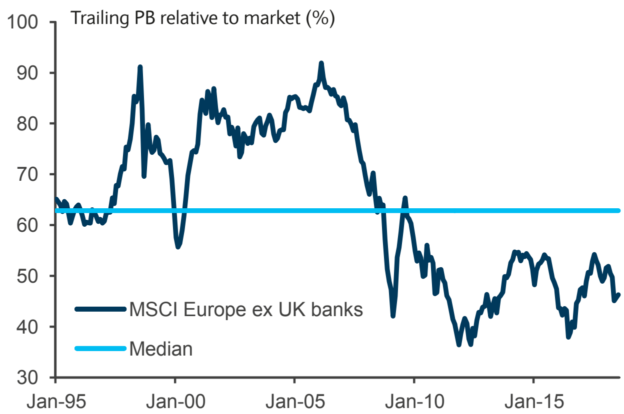
Investors will not need long memories to work out why this is not an investment for all risk appetites. Notwithstanding the aforementioned hurdles, the sector remains hostage to European political uncertainty, with the most recent example being Italian politics, which seemed to draw attention away from a marginally improving picture of underlying fundamentals. Meanwhile, risks of rising trade protectionism threaten to derail growth momentum, and the cyclical tailwinds for bank profitability with it. Turkey's recent currency crisis has also weighed on sentiment, given fears regarding some of the bank's exposure to Turkish assets. So far, estimates suggest minimal exposures to Turkey outside of a select few banks. A further deterioration in the Turkish situation isn't implausible, but unlikely to pose a systemic solvency risk to the wider sector. Valuations are currently low relative to history (Figure 2), thus implying higher upside potential should our base scenario play out as expected. All in all, the sector remains an attractively priced, albeit risky, long-term play on European growth. Nerves of steel and patience are still required, but still likely to be rewarded in our view.

Figure 1: Loan growth picking up



Source: ECB, Barclays

Figure 2: Relative valuations remain low



Source: Factset, Barclays

Investments can fall as well as rise in value. Your capital or the income generated from your investment may be at risk.

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