

# Holiday Stress Tests

> DECEMBER 2018  
NEWSLETTER

## European bank stocks may be the positive surprise of 2019.

Bruised UK and Continental European bank shares, represented by the MSCI European Bank Index, have spent the second half of 2018 in a merciless valuation de-rating. We believe they are oversold. European bank stocks may be the positive surprise of 2019. Despite abundant levels of capital, rising dividend payout ratios, and falling non-performing loan (“NPL”) ratios, these stocks have suffered from doubts about European Union (“EU”) integration and potential ramifications of various Brexit scenarios. In local currency, the Euro STOXX Banks Index has declined 25% over the year-to-date period, while the UK FTSE All-Share Banks Index has given up 15% over the same period.

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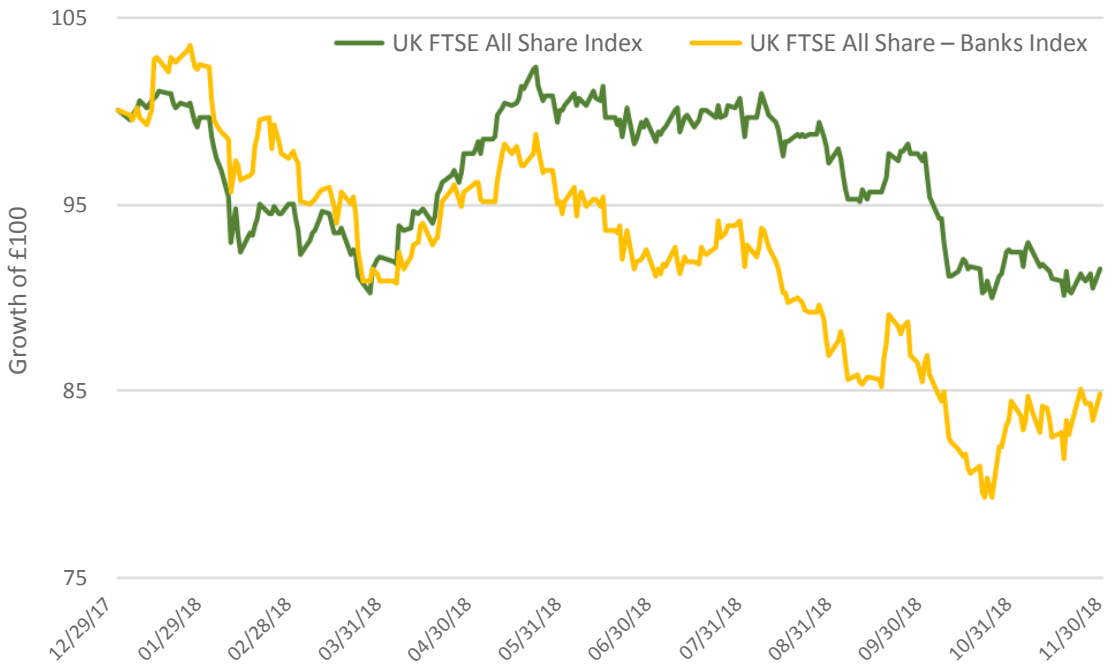
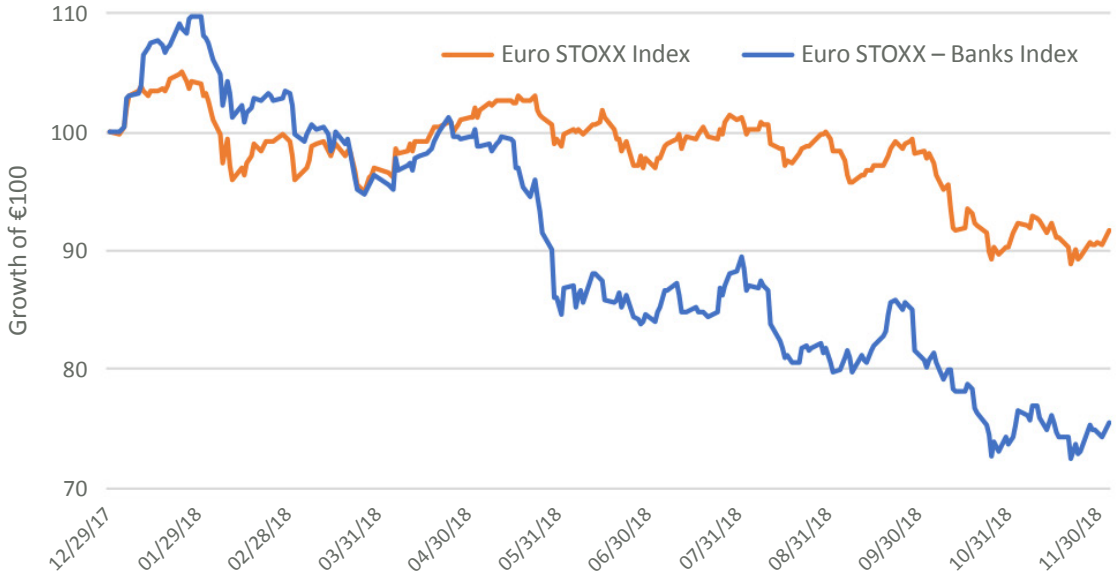
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In our estimate, these bank indices did not start the year overvalued. However, in recent months, Europe’s economic outlook has dimmed, and European financial sector equities have de-rated further. Banks tend to be economy- and stock market-sensitive (high beta), and thus characteristically underperform in falling markets. However, recalling the value mantra, “There’s a price for everything,” we cannot explain why some of the most operationally improved bank stocks (generating — in some cases — record high earnings and capital) have sunk to near crisis level valuations. Are we entering a crisis? We do not see one on the horizon. Central banks have

## European Bank Stocks Have Underperformed the Broader Market Year-to-Date

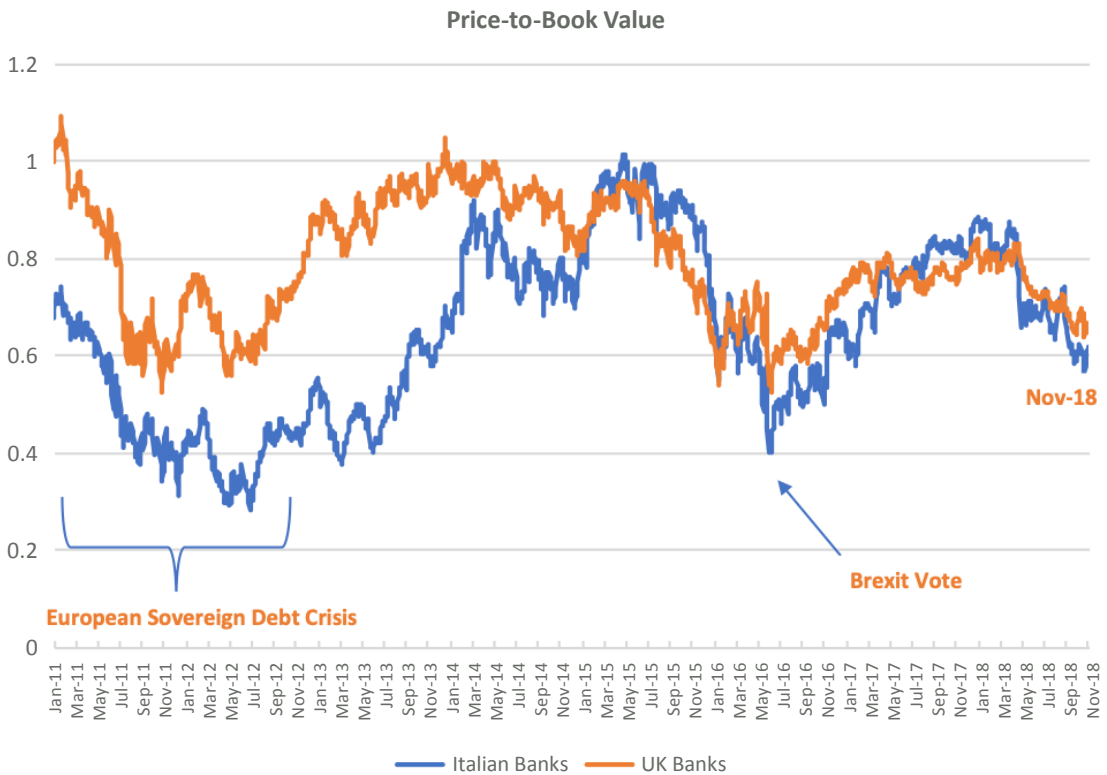


Source: FactSet. Year-to-date price return, as of 12/3/2018, in local currency. Beginning values indexed to 100. See Disclosures.

armed themselves with liquidity measures to forestall economic disruption and protect their respective financial systems.

Several of the largest European banks recently have passed stringent capital adequacy stress tests. These well-capitalized banks are trading near the lowest current and prospective price-to-book value, price-to-tangible book, and price-to-earnings multiples seen since the euro zone banking crisis of 2011. The unweighted dividend yield of the five major UK banks is over 5% for 2019, and several have declared that they will deploy excess capital in share buybacks. Major Italian banks have disposed of most of their bad debts and worked assiduously to widen the gap between revenue growth and cost growth (known to bank analysts as

## UK and Italian Bank Valuations are Nearing Crisis Levels



Source: FactSet. Italian Banks series is the unweighted average of the price-to-book value of the banks in the MSCI Italy Index-Banks. UK Banks series is the unweighted average of the banks in the MSCI United Kingdom Index-Banks, other than HSBC (we believe HSBC fundamentals are more tied to Asia).

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the “operating jaws”). Banks have two primary levers to improve shareholder returns: cost control and capital management. Well-managed banks do both. We look for adept bank management teams who focus on disciplined underwriting and cost efficiency, creating a buffer to offset any revenue headwinds.

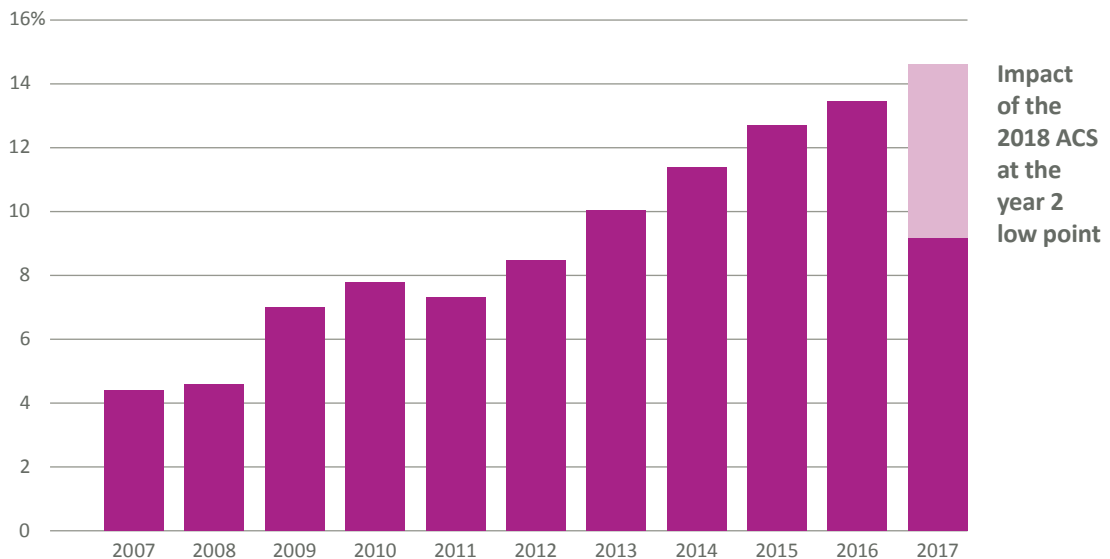
Admittedly, further deterioration of Italy’s financial health could result in major spillovers in the euro area and in the United Kingdom. The Italian government’s lack of fiscal austerity means potentially higher levels of Italian public debt — at 131% of gross domestic product (“GDP”), already among Europe’s highest. Italian banks are among the largest holders of Italian public debt and thus have significant perceived sovereign risk. Without more relief from central bank liquidity, Italian banks could experience rising funding costs, that — if passed on to households and businesses — could depress already weak growth and lead to a proliferation of bad debts. Italian NPLs already account for over 25% of all euro zone NPLs. The current Italian government may prove more fiscally frugal — out of necessity — than markets anticipate in order to avoid punitive sanctions. Regardless of the politics, we believe that euro zone banks in our fundamental client portfolios have plenty of capital.

The European Banking Authority (“EBA”) recently published the results of the 2018 EU-wide stress test of 48 banks. Commenting on the outcome of the exercise, Mario Quagliariello, Director of Economic Analysis and Statistics at the EBA, said: “The outcome of the stress test shows that banks’ efforts to build up their capital base in the recent years have contributed to strengthening their resilience and capacity to withstand the severe shocks and material capital impacts of the 2018 exercise. The results will be used by supervisors as part of their wider assessment of banks’ vulnerabilities and input to their supervisory decisions.” In the United Kingdom, bank regulators demand a crisis proof

financial system. In its November 2018 Financial Stability Report, the Bank of England (“BOE”) claims: “The UK banking system is resilient to deep simultaneous recessions in the UK and global economies that are more severe overall than the global financial crisis and that are combined with large falls in asset prices and a separate stress of misconduct costs.” The BOE’s worst case scenario assumptions include (deep breath...): world GDP falls 2.4%, UK GDP shrinks by 4.7%, UK unemployment rises to 9.5%, UK residential property prices plunge 33%, UK commercial real estate prices collapse by 40%, and the pound sterling exchange rate index declines 27%. This scenario envisions rapid imposition of trade barriers with the EU, loss of existing trade agreements with other countries, severe customs disruption,

## Strengthening UK Bank Capital Positions: Even at its Lowest Levels in the Stress Test, the Aggregate Capital Ratio is Still More than Double What it Was Before the Financial Crisis

Aggregate CET1 capital ratio of major UK banks since the financial crisis



Sources: Bank of England Financial Stability Report. PRA regulatory returns, published accounts, participating banks’ STDF data submissions, bank analysis and calculations. The CET1 capital ratio is defined as CET1 capital expressed as a percentage of risk-weighted assets. Major UK banks, as identified in the report, are Barclays, The Co-operative Bank (until 2013), HSBC, Lloyds Banking Group, Nationwide, The Royal Bank of Scotland, Santander UK and Standard Chartered (from 2014). From 2011, data are CET1 capital ratios as reported by banks. Prior to 2011, data are bank estimates of banks’ CET1 ratios. Capital figures are year-end. The impact of the 2018 ACS does not include the conversion of AT1 instruments.

**Today, UK banks have 3.5 times the capital they held in 2008, while conducting considerably less risky operations.**

sizable rise in risk premium on UK assets, and loss of confidence and other negative spillovers to UK financial markets. Even this nightmarish outcome would leave UK major banks with capital ratios twice pre-2008 levels. Today, UK banks have 3.5 times the capital they held in 2008, while conducting considerably less risky operations. Furthermore, they are funded more by low risk deposits than volatile wholesale liquidity. Consensus sell-side 2020 estimates for the major UK banks imply an aggregate capital cushion of GBP30 billion available for distribution.

What about Brexit? If the House of Commons accepts Prime Minister May's current Brexit deal, then it must be approved by all 27 EU governments. In that case, an orderly transition period would begin after March 29, 2019. If the UK government rejects the deal and no action is taken to delay withdrawal under Article 50, Britain will leave the EU – the “disorderly” exit scenario. At that juncture, for the UK, EU trade rules become World Trade Organization rules.

Why would government leaders, most of whom desire to keep political power, cripple their country's economy? At risk are vital operations such as healthcare and supply of medicines, safety/crime fighting collaboration, air traffic control, citizen's legal status, electricity and gas interconnection, and ports operations, to name a few. The Association for Financial Markets in Europe has identified significant unresolved risks such as continuity of contracts, and access to infrastructure like clearing, trade repositories, and cross-border data flows. A disorderly departure from the EU would put downward pressure on the UK's important auto industry. Reconfiguring supply chains to accommodate the new trade status would take years (if even possible). The EU is Britain's biggest trading partner, and departure could mean a drop in cross-border trade of as much as 40%. A trading decline of this magnitude

could threaten foreign investment, which is unusually high in Britain relative to the rest of Europe. Ending free movement of labor would also curb valuable EU immigration. And all three factors would further reduce productivity growth.

What electorate would allow such economic self-destruction? We suggest none, as we believe will be evident in the coming weeks and months. In the meantime, investors can buy shares in well-capitalized UK and Continental European banks at crisis valuations. We expect the banks with the most abundant levels of capital to accelerate their share buyback plans and raise dividend payout ratios. Investors should expect some compensation for their patience as political rationality returns to Europe, which we believe will occur next year — if not sooner.

#### **Important Disclosures**

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The STOXX Indices are published by STOXX Limited, owned by Deutsche Borse AG and SIX Group AG. These indexes cover a wide range of market segments including the broad market, blue chips, individual sectors and global indexes. The Euro STOXX Banks Index uses the ICB Industry Classification Benchmark, which categorizes companies according to their primary source of revenue, to identify banks. The UK FTSE All Share Index is designed to represent the performance of UK companies, providing market participants with a set of indexes that measure the performance of all capital and industry segments of the UK equity market. It represents 98-99% of the UK market capitalization. The UK FTSE All Share Banks Index focuses on banks. The MSCI Italy Index is designed to measure the performance of the large and mid cap segments of the Italian market. With 24 constituents, the index covers about 85% of the equity universe in Italy. The MSCI United Kingdom Index is designed to measure the performance of the large and mid cap segments of the UK market. With 100 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the UK. Within these indices, the respective banks indices measure the performance of securities classified in the Banks industry group (within the Financials sector) according to the Global Industry Classification Standard. It is not possible to invest in directly in an index.

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