

Time to look at bank bonds?

Compelling value opportunity, solid fundamentals

M&G Public Fixed Income

December 2022

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- Banks are currently one of our favoured sector calls in the fixed income space, providing resilient fundamentals, compelling valuations and attractive new issue premiums.
 - We believe banks are in a much stronger position than in 2008 and should be well-placed to withstand an economic slowdown given their robust capital positions.
 - Banks have also been benefiting from the current higher interest rate environment, as they are able to capture a higher net interest margin on their lending activity.
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The value and income from a fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise and you may get back less than you originally invested. Where any performance is mentioned, please note that past performance is not a guide to future performance.

Banks are currently one of our favoured areas within global fixed income markets, as we believe the sector offers resilient fundamentals and compelling valuations. We believe that banks today are in a much better shape than in 2008, being strongly capitalised and well placed to withstand a recessionary environment. Banks also generally benefit from higher interest rates, since they are able to capture a wider spread between their lending and deposit rates. Despite these positive factors, banks currently trade at a significant discount to other sectors having sold off sharply in 2022. We are finding especially good value in the primary market where we are currently seeing an attractive new issue premium amongst many high-quality banking names.

Robust fundamentals

From a fundamental perspective, we believe banks are in a much stronger position than in 2008. While banks would clearly not be immune to a severe economic downturn, we believe the sector is managed in a much more prudent manner than was previously the case and should be able to withstand a more recessionary environment.

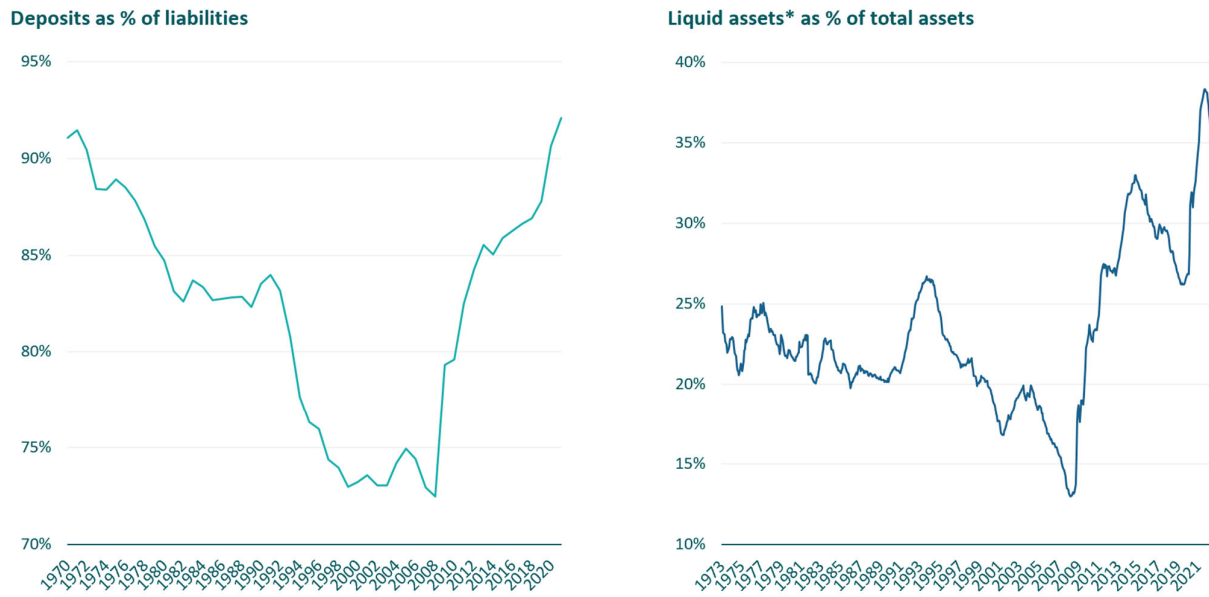
In stark contrast to 2008, **US banks** today are both highly liquid and well-capitalised. Deposits now represent more than 90% of liabilities, compared to around 75% before the financial crisis. Highly liquid assets (ie, cash, treasuries and agency bonds) make up around 35% of total assets, compared to a pre-2008 range of around 15-20% (see Figure 1).

It is a similar story in **Europe**, where asset quality and underwriting standards have greatly improved over the past decade. According to the European Central Bank, non-performing loan ratios have declined from 8% in 2015 to less than 2% today. **Common Equity Tier 1 (CET1)** ratios – which measure a bank's core equity capital versus its total risk-weighted assets – are today in the 12-14% range. This is comfortably in excess of the minimum Basel III requirements of 7% and suggests that European banks have a significant buffer to withstand financial stress and maintain solvency.

Banks have also been benefiting from the current higher interest rate environment, as they are able to capture higher **net interest margins** on their lending activity. We believe this should provide a meaningful uplift to bank revenues, helping to partly offset losses which may arise from an increase in bad loans as the global economy slows.

Another factor that we would expect to boost bank profitability is the continued shift towards **digital banking**. As increasing numbers of customers migrate to digital channels, banks should be able to reduce their number of physical branches, which in turn should help to significantly reduce their fixed costs.

Figure 1. US banks are highly liquid and well-capitalised



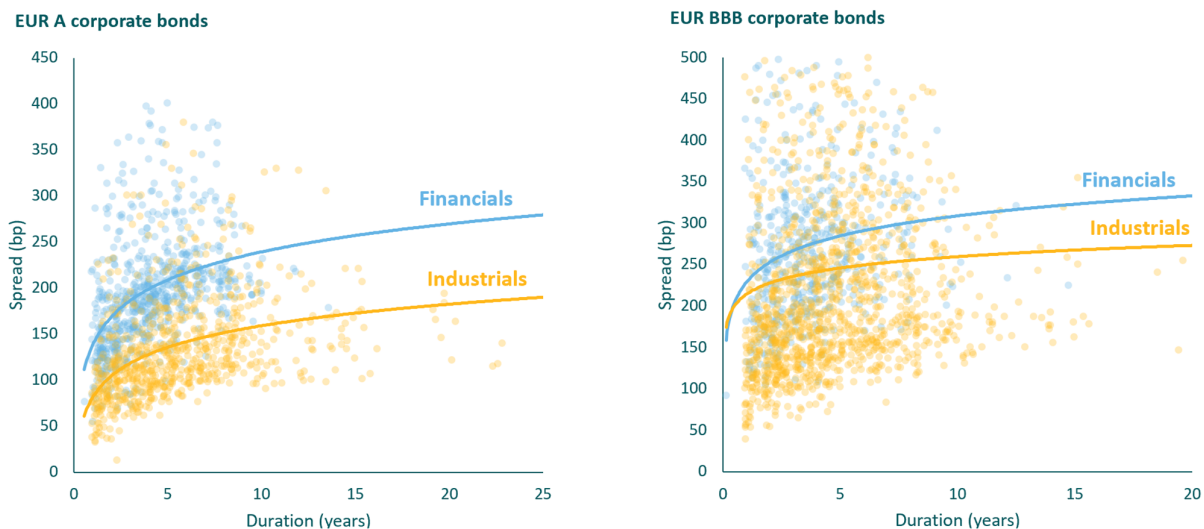
Source: Bloomberg, 31 October 2022 (latest data available). *cash+Treasury+Agency

Compelling valuations

While the probability of a global recession has increased, the magnitude of the recession is still very much up for debate. Our view is that we are starting from a much stronger position than in 2008 – both household and company balance sheets are in a decent shape and the economy as a whole contains far less leverage. As a result, we are not expecting corporate defaults to increase to the levels currently priced in by markets and we believe corporate bond investors are being well paid to take credit risk.

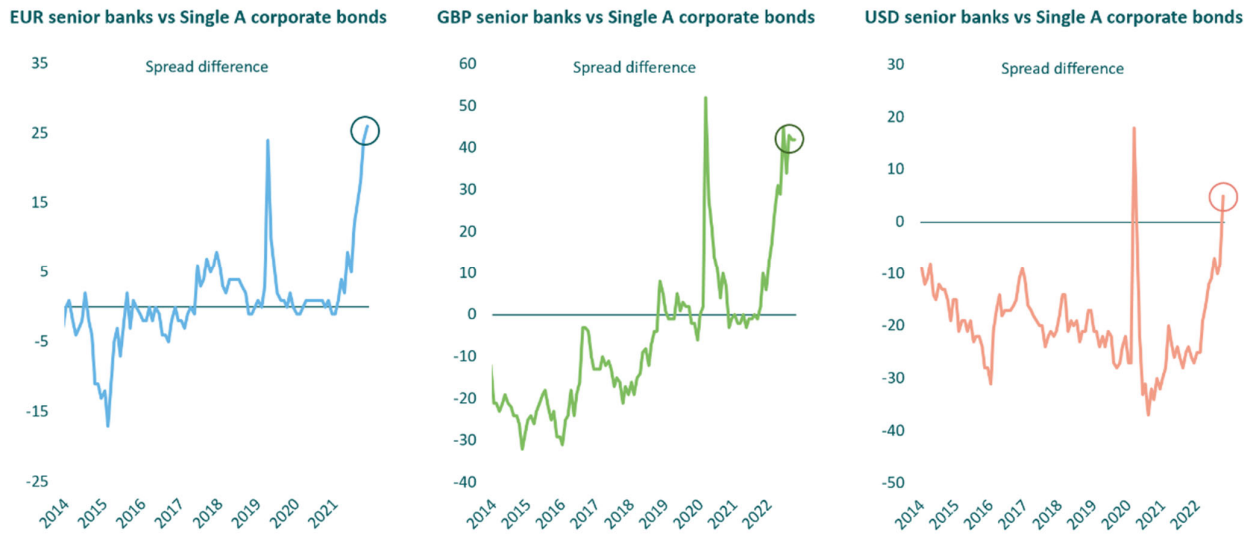
This is particularly the case within the banking sector, which we think appears cheap not only in absolute terms, but also in relative terms. For instance, European financials offer a meaningful spread pick-up versus industrials across all maturities (see Figure 2). The spread differential also appears wide versus historic levels, with senior bank bonds looking good value versus single A corporate bonds across Europe, the UK and the US (see Figure 3).

Figure 2. Financials appear cheap versus non-financials



Source: Bloomberg, 16 October 2022

Figure 3. Financials vs non-financials – spread differentials over time



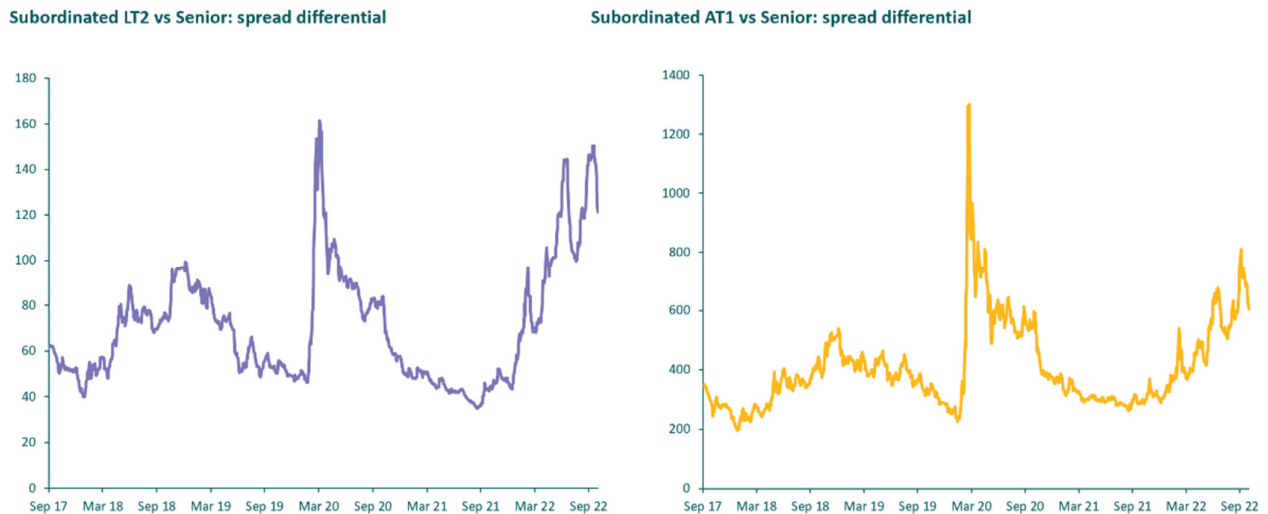
Source: Bloomberg, 31 October 2022

Past performance is not a guide to future performance

Looking across the capital structure, we think **subordinated bank debt** generally looks attractive versus senior debt. Subordinated debt ranks below senior debt, which means in the event of a default subordinated bondholders would only be paid once more senior creditors are repaid in full. Subordinated bonds are therefore riskier, although investors would usually be compensated for this additional risk through a higher income stream.

However, it is important to be selective when investing in subordinated financial bonds. For instance, the spread differential between **Lower Tier 2 (LT2)** bonds and senior bonds is now back to the highs reached during the COVID crisis, suggesting attractive relative value in these instruments. However, another category of subordinated debt – **Additional Tier 1 (AT1)** bonds – does not appear especially cheap on a relative basis, with spread differentials versus senior bonds still some way off their COVID wides.

Figure 4. Senior v subordinated financials - spread differentials over time



Source: M&G, Bloomberg, Bloomberg Euro Aggregate Banking Seniors Index, Bloomberg Banking LT2 Index, Bloomberg Capital Securities Index as at 31 October 2022

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Attractive new issue premiums

Throughout 2020 and 2021, companies took advantage of the very low interest rate environment by re-financing a significant amount of their debt over an extended period. As a result, companies have had ample liquidity and have not needed to issue large volumes of new debt as borrowing costs have soared in 2022. This has led to a material decline in bond issuance across most sectors over the past year.

However, banks generally rely on a regular flow of capital, both for their operational needs and to fulfil various balance sheet requirements. As a result, banks have continued to issue large volumes of debt in 2022, with net bond issuance well in excess of other sectors over the past year.

The market has therefore had to absorb a relatively large amount of bond issuance in the banking sector, which has resulted in an attractive **new issue premium** – this is where newly issued bonds price at a higher spread compared to similar bonds already trading on the secondary market. As large investors, we are well placed to participate in these new deals on attractive terms.

From a technical perspective, it is also worth noting that bank bonds should not be directly impacted by **Quantitative Tightening (QT)** – the process where central banks sell their assets back to the market. Under their **Quantitative Easing (QE)** programmes, central banks purchased vast quantities of corporate bonds, particularly in Europe. As QE is reversed, these bonds could come under selling pressure as central banks seek to shrink their balance sheets. However, bank bonds were not included in the QE programmes and should therefore not be directly impacted in a QT environment.

A constructive outlook for banks

Given their strong fundamentals and compelling valuations, we remain constructive on banks. However, it is important to be selective in this area, and we generally favour the larger national banks with resilient balance sheets and a dominant market position. Other key qualities we look for include strong capital buffers, diversified sources of funding and a good track record of managing risk throughout the economic cycle. Given the current inflation situation, we also prefer banks that are less exposed to consumers in lower income cohorts, which tend to be most heavily impacted by rising inflation and energy prices. From a regional perspective, we generally have a preference towards euro-denominated issues, primarily on valuation grounds.

Investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the portfolio. High yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.

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