RBC Global Asset Management

Four reasons to invest in financials

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Marc Stacey
Senior Portfolio Manager
BlueBay Fixed Income Team

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The fundamental resilience of banks is not being fully reflected in valuations and we are confident that this should correct over time. Even in light of a possible recession, the sector will be coming into any economic downturn from a position of strength, and perhaps the best position it has ever been in, at this point in the cycle.

Here investment grade financials specialist Marc Stacey outlines the four top reasons to consider financials:

1. Asset quality trends continue to be robust and reassuring
2. Banks continue to benefit from tailwinds
3. Financials are trading at attractive valuations versus non-financials
4. Yields are close to historical highs

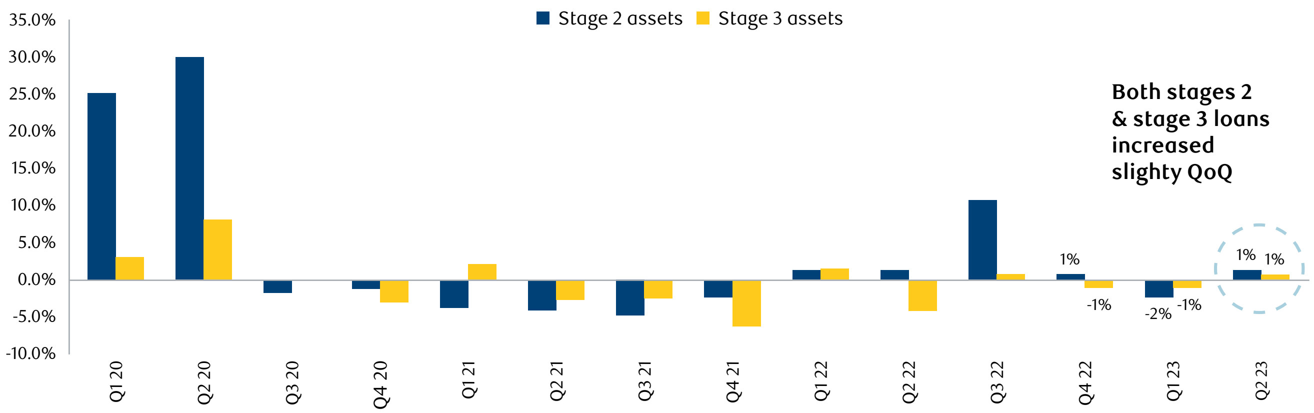
1. Asset quality trends continue to be robust and reassuring

- The most common explanation we hear to try and explain the valuation gap is that as economies enter recession, defaults will increase, asset quality will deteriorate aggressively, and banks will suffer as a consequence.
- While we expect default rates to pick up and asset quality to deteriorate, this will likely play out slowly.
- Credit deterioration is most correlated with rising unemployment, which for the time being remains very low.
- European banks' Q2 provisioning charge was just 31 basis points (bps), compared to a normalised through the cycle level of 50bps.
- In addition, banks have been conservative in taking precautionary provisions, with the sector in aggregate carrying over 6 months worth of provisions for loans that continue to perform.
- Further, in our view, regulatory oversight of banks has greatly curtailed risk taking, and tighter lending restrictions over the past cycle will drive a stronger through the cycle asset quality performance for the sector.

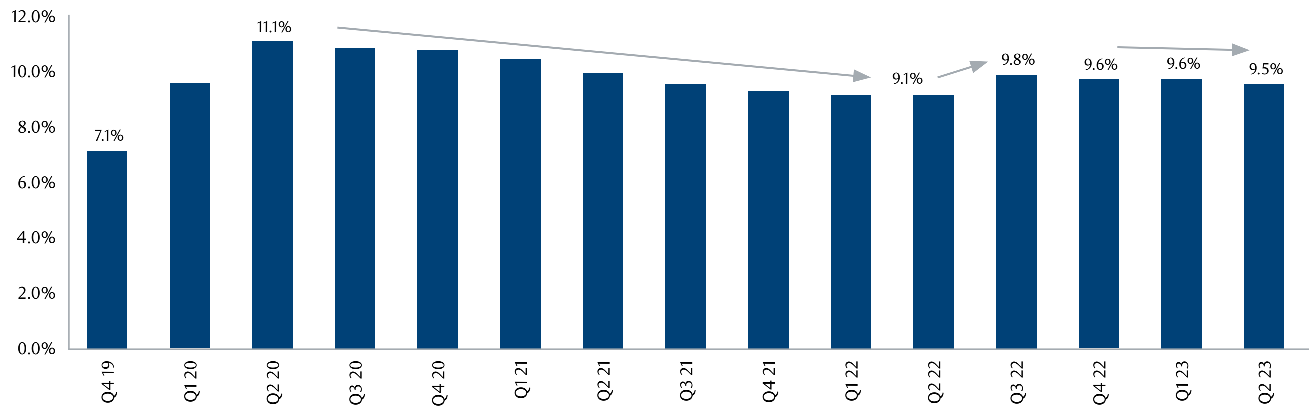
Q2 2023 asset quality trends continue to be robust and reassuring

Quarter-on-Quarter trends in Stage 2 assets and Stage 3 Non-performing loans (NPLs) were benign.
Under IFRS 9, applicable entities must now place financial instruments into three distinct stages, including "performing" (Stage 1), "underperforming" (Stage 2) and "non-performing" (Stage 3).

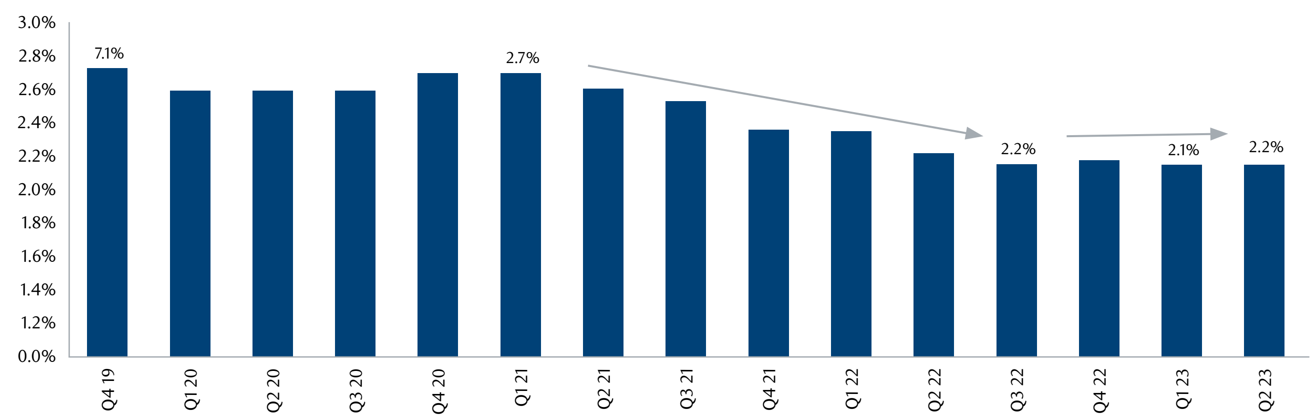
QoQ movement in assets



Stage 2 loans as % total loans



Stage 3 NPLs as % total loans



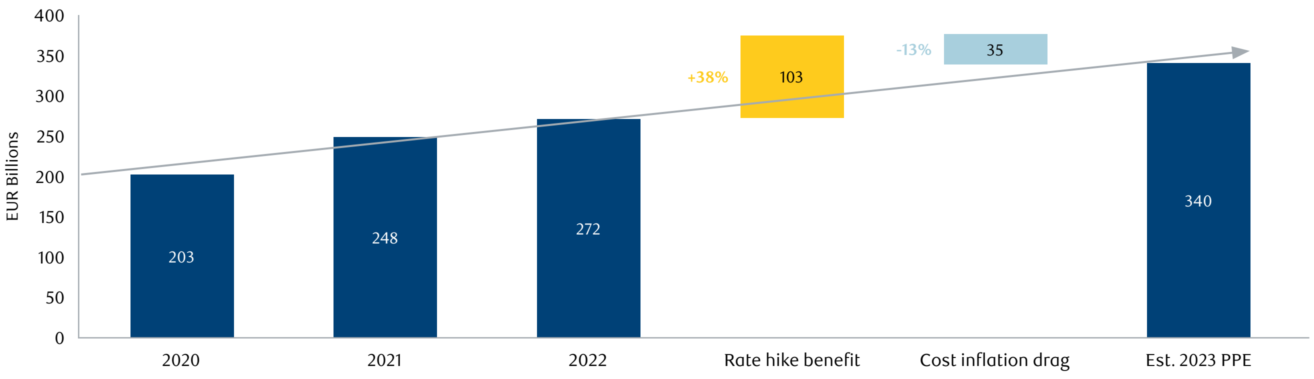
Source: Company data / autonomous research, as at June 2023.

2. Banks continue to benefit from tailwinds

- Banks continue to benefit from huge tailwinds as a result of higher rates, with profitability soaring over the last few years.
- This profitability tailwind gives credit investors increased confidence that even if asset quality starts to deteriorate, any provisioning increase will be comfortably absorbed by the improved earnings environment.

Pre-provision earnings are likely to be up circa 70% since 2020.

Higher rates boosting loss-absorbing capacity



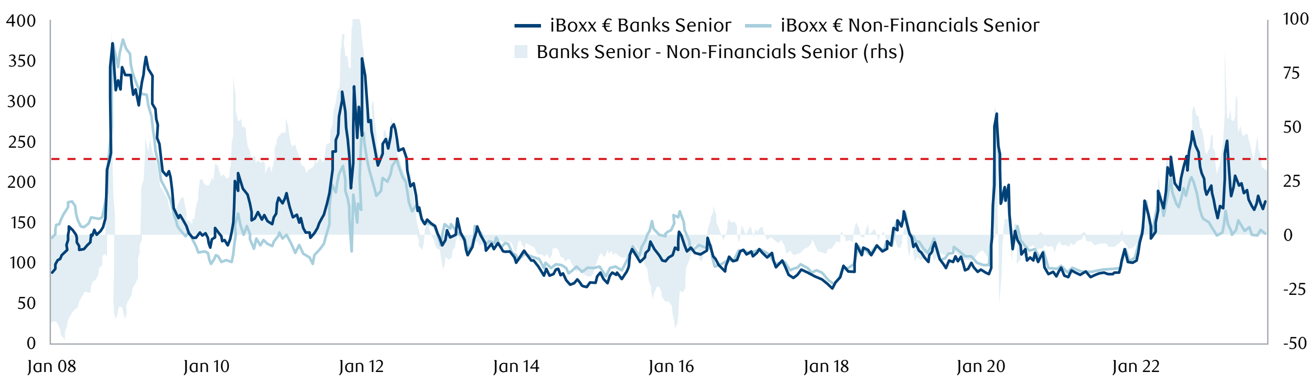
Source: RBC Global Asset Management as at 31 January 2023.

3. Financials are trading at attractive valuations versus non-financials

- This is true both in credit and equities, as a consequence of the US regional and Credit Suisse events in H1 2023.
- The red dotted line below represents the differential between senior financials and non-financials.
- It is counterintuitive to us that this relationship exists. Higher rates increase funding costs and coverage ratios for corporates, but are a profitability driver for banks.

A few times in history, we have traded at a wider differential.

iBoxx € Corp Subindices, G-Spreads in bps

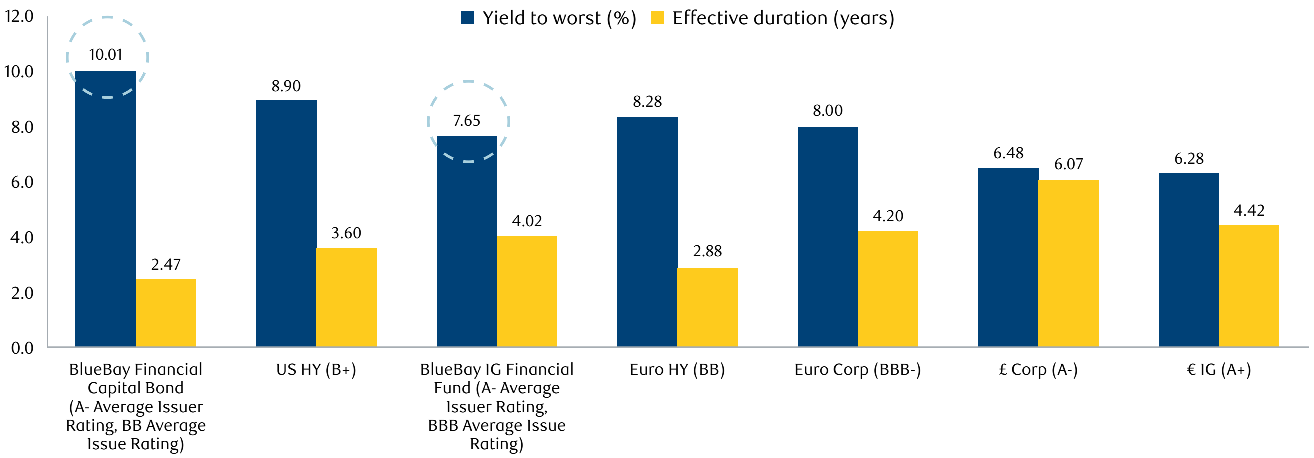


Source: Deutsche Bank, IHS Markit as at 29 September 2023.

4. Yields are close to historical highs

- Due to higher government bond yields and wider financial spreads, yields are close to historical highs and offer attractive value versus their underlying credit quality.

Yields and durations of various sub asset classes in USD



Source: RBC Global Asset Management, Bloomberg, as at 29 September 2023.

Investors sacrifice minimal yield while investing in a highly rated investment grade portfolio

Looking ahead

In summary, the fundamental resilience of banks is not being fully reflected in valuations, and we are confident this should correct over time. Even in light of a possible recession, the sector will be coming into the economic downturn from a position of strength and perhaps the best position it has ever been in at this point in the cycle.

What is somewhat different in this potential recession is that central banks are raising rates to fight inflation, which is helpful from a bank earnings perspective and should go some way in shielding any deterioration in asset quality. Capital levels remain close to all-time highs, while the stock of NPLs is close to the lows.

Although we are conscious that these factors are often overlooked in times of stress, fundamentals always reassert themselves eventually, and we believe European banks are likely to offer investors an upside as a more severe economic recession is arguably already being priced into valuations.

Risk Characteristics

- At times, the market for investment grade bonds or high yield bonds may dry up, which could make it difficult to sell these bonds, or the fund may only be able to sell them at a discount.
- There may be cases where an organisation with which we trade assets or derivatives (usually a financial institution such as a bank) may be unable to fulfil its obligations, which could cause losses to the fund.
- Investing in subordinated bank debt, including CoCos, offers you the chance to gain higher returns through growing your capital and generating income. Nevertheless, there is a risk that CoCos may 1) be converted to equities or permanently written down 2) not be redeemed by the issuer when expected 3) defer or cancel interest payments indefinitely, which would result in a loss of income to the fund and possible loss of its initial investment. Additionally, CoCo investors may suffer losses prior to investors in the same financial institution holding equities or bonds.
- BlueBay's ESG analysis can rely on input from external providers. Such data may be inaccurate or incomplete or unavailable and BlueBay could assess the ESG risks of securities held incorrectly.
- BlueBay could suffer from a failure of its processes, systems and controls – or from such a failure at an organisation on which we rely in order to deliver our services – which could lead to losses for the fund.

RBC Global Asset Management (U.S.) Inc.
Minneapolis | Boston | Chicago
800.553.2143 | **rbcgam.com**