

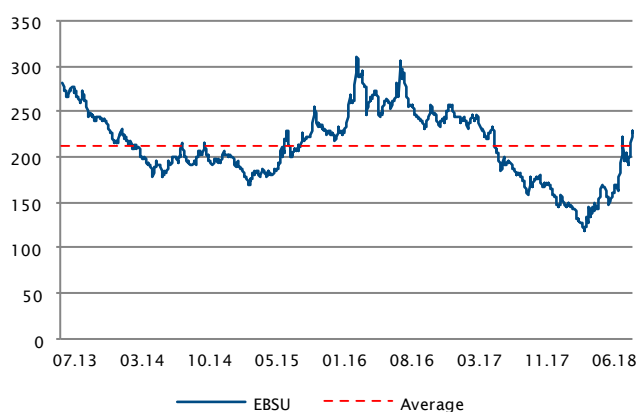
EUROPEAN BANKS AND THE SEARCH FOR VALUE

HIGHLIGHTS

European banks remain one of our highest conviction sectors within credit as a number of developments in monetary policy, banking fundamentals and regulatory changes should support positive performance during the rest of the year.

The bullishness in credit markets we saw at the end of 2017, which continued into the first weeks of January 2018, got abruptly disrupted by inflation fears, followed by trade concerns that were seen as a potential threat to global growth and finally political uncertainty in Italy. The result was a widening of spreads across credit sectors that did not leave banks unaffected. The banking sector of the European financial subordinated index¹ reported a spread widening of approximately 65 basis points from 140bps at the start of January to 207bps at the 25th of July.

EBSU option adjusted spread and average



Sources: Bloomberg, SYZ Asset Management
Data as at: 30 June 2018

Interestingly, the European AT1² market spread widening was entirely price/market sentiment driven, as there were no significant rate movements, indicating that this widening could be materially reversed to the extent that peripheral political risks recede.

Monetary policy conditions, bank fundamentals and new financial regulations support the above view. Consider the following:

1. ICE BofA European financial subordinated index (EBSU)
2. Additional Tier 1 securities



Michalis Ditsas

Investment Specialist

“A combination of solid fundamentals and positive valuations indicate that European banks are an attractive opportunity within credit.”

Monetary Policy

As discussed in our [European credit outlook for H2 2018](#), today there is a very low risk of unexpected ‘hawkish’ shocks as the hiking cycle signalled by the Fed is already priced in and the ECB has continued to be transparent in reaffirming its very cautious and supportive stance. The market is discounting an increase in risk free rates but this will have limited impact on risky asset valuations. Furthermore, the establishment of emergency monetary policy mechanisms, namely the ESM, OMT and banking union, are reinforcing the toolkit that the ECB has at its disposal in order to ensure price and financial stability across Europe.

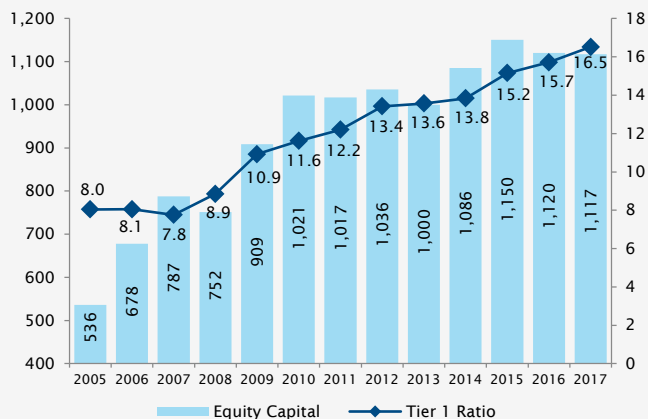
Bank Fundamentals

The financial system continued its balance sheet strengthening with higher levels of equity capital and improved asset quality. Eurozone banking institutions have piled on billions of fresh equity capital since the end of 2010, at the same time reducing their bad loan exposure from 2015 peaks to the current Non-performing Loan ratio of 4.9%.

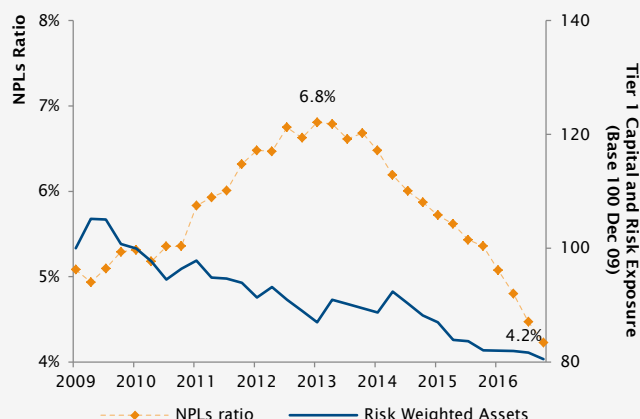
Financial Regulations

The ECB recently announced further steps towards addressing the stock of banks NPL’s by shifting from a common target for the entire EU banking system to a supervisory approach that will consist of bank-specific targeting of NPLs reductions in order to avoid discrepancies between banks and among countries. In addition, the ECB can impose Pillar 2 requirements that would force banks to address any NPL issues. This increase in financial regulations is a positive development for Italian and Spanish banks in particular as it will reduce the risk of sudden recapitalization and the forced sale of NPL’s. For investors, a practical impact of these regulations will be the likely increase in issuance which will provide further investment opportunities.

Core Equity more than doubled over the last 10 years



Derisking & asset quality improvement



Sources: EBA Risk Dashboard, Bloomberg, SYZ Asset Management
Data as at: 29 December 2017

Favourable tailwinds, but a robust approach needed

Our credit team uses proprietary models to evaluate the robustness of banks by stress testing balance sheets and estimating the probability of adverse events (e.g. conversions/coupon cancellations) for instruments such as CoCos (Contingent Convertibles). The results indicate that all 32 banks in our sample have sufficient buffer not only for 2018, but also for the more demanding regulations that they will face during 2019³.

Conclusion

Spreads of the ICE BofAML Subordinated Euro Financial Index have rebased around the 5 year average, which results in attractive valuations. In addition, CoCo's are offering attractive carry relative to other asset classes. These characteristics combined with solid banking fundamentals, positive regulatory developments, political risks that are either priced-in or have faded out and an overall stable economic environment make the asset class one of the most attractive places to invest this year.

3. Fully loaded CET1 ratio updated at Q1 2018, while capital requirements could be revised by regulators after the outcome of the stress tests and the SREP process.

Our proprietary models indicate that banks can withstand the impact of increased regulation

BANK	CET1	BUFFER BEFORE COUPON CANCELLATION: 2018	BUFFER BEFORE COUPON CANCELLATION: 2019
LLOYDS	14.40%	3.53%	0.60%
BNP	11.60%	2.08%	1.33%
BBVASM	11.10%	2.66%	1.40%
SANTAN	11.19%	2.33%	1.43%
DB	13.40%	2.46%	1.45%
BGAV	13.50%	2.18%	1.55%
SOCGEN	11.20%	2.50%	1.60%
BACR	12.70%	2.33%	1.80%
ACAFFP	11.70%	3.07%	1.90%
RBIIV	12.20%	2.50%	1.95%
ERSTBK	14.40%	5.03%	2.15%
HSBC	14.50%	3.86%	2.50%
INTNED	14.28%	3.88%	2.51%
CMZB	13.30%	3.18%	2.55%
SABSM	12.90%	4.29%	2.70%
BKIASM	13.89%	4.71%	2.80%
CABKSM	11.80%	3.74%	2.85%
UCGIM	13.13%	3.94%	3.24%
ISPIM	13.30%	5.16%	3.24%
RABOBK	15.00%	4.63%	3.25%
STANLN	13.60%	4.20%	3.48%
CCBGBB	16.30%	4.68%	3.85%
BPCEGP	15.30%	5.27%	4.70%
RBS	16.40%	6.18%	4.80%
ABNAV	17.53%	6.54%	5.23%
KBCBB	15.88%	6.01%	5.28%
DANBNK	16.40%	7.03%	5.40%
BKIR	15.80%	6.88%	6.25%
NYKRE	21.50%	12.63%	8.38%
AIB	20.80%	9.43%	8.80%
AARB	19.60%	11.36%	10.74%
NWIDE	30.50%	19.80%	18.80%

Sources: SYZ Asset Management
Data as at: 31 July 2018