

FUNDAMENTALS FOR EUROPEAN BANKS HAVE NEVER BEEN STRONGER

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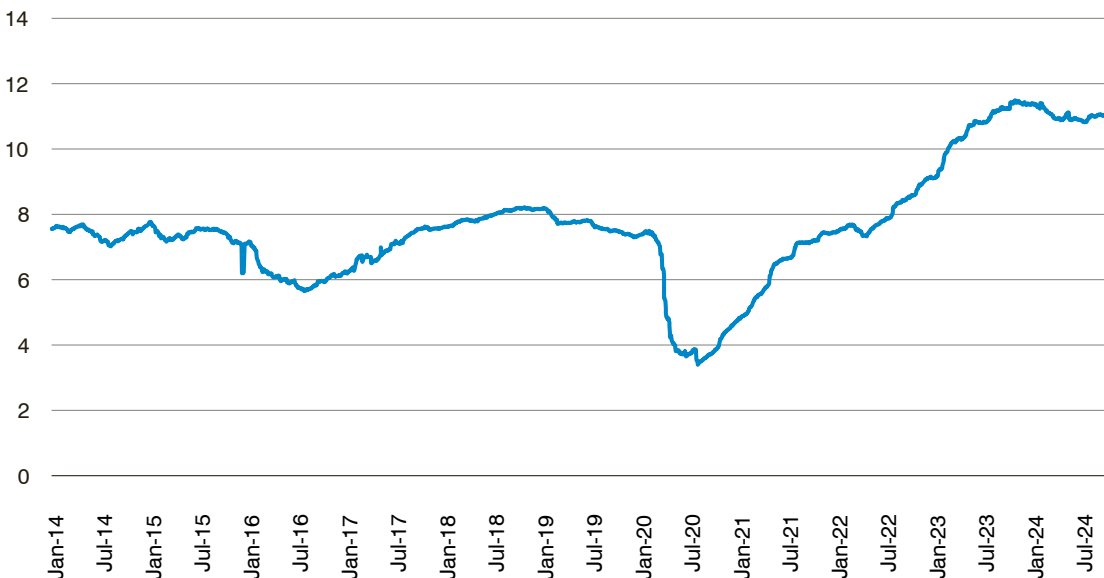
Atlanticomnium’s Romain Migniac discusses the strong fundamentals of European banks and his latest perspective on the pricing of extension risk.

We believe there has never been a better time to be a bondholder in subordinated debt issued by companies in the financial sector, benefitting from a boost in profitability on top of rock-solid fundamentals. As shown in Chart 1, the return on equity (ROE) from the banking sector is expected to remain high over the next 12 months. Previously, before interest rates were significantly increased, the return on equity was around 6% to 7%. Now, in the foreseeable future, we are looking at ROE of 10% or more.



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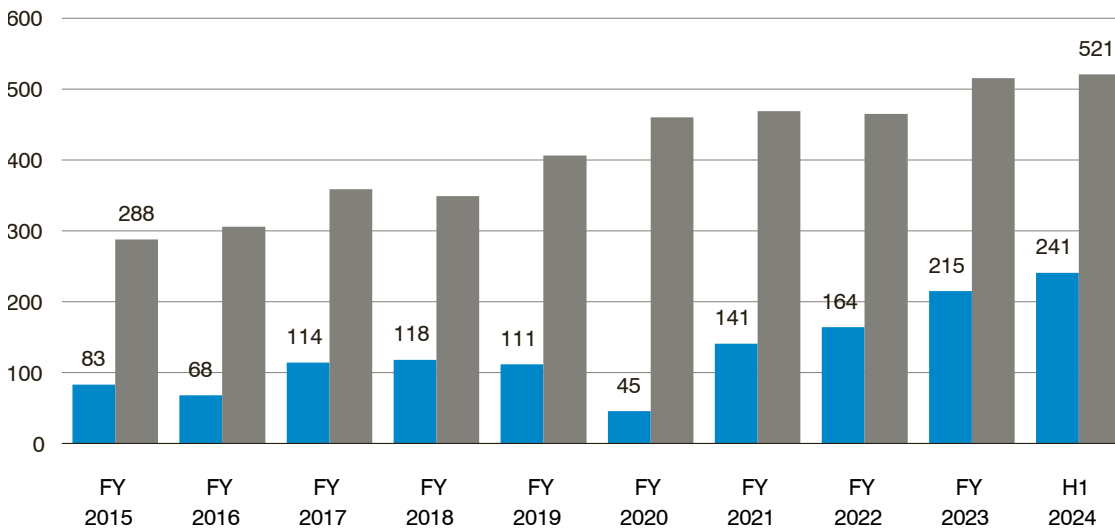
Chart 1: European banks expected to make a comfortable double-digit ROE over next 12 months



Source: Atlanticomnium and Bloomberg, as at October 2024. Past and current trends should not be relied upon as an indicator of future trends. The views are those of the manager and are subject to change.

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Chart 2: EU Banks' earnings and capital buffer has increased by circa 350 billion euro over past decade to record highs of circa 750 billion euro



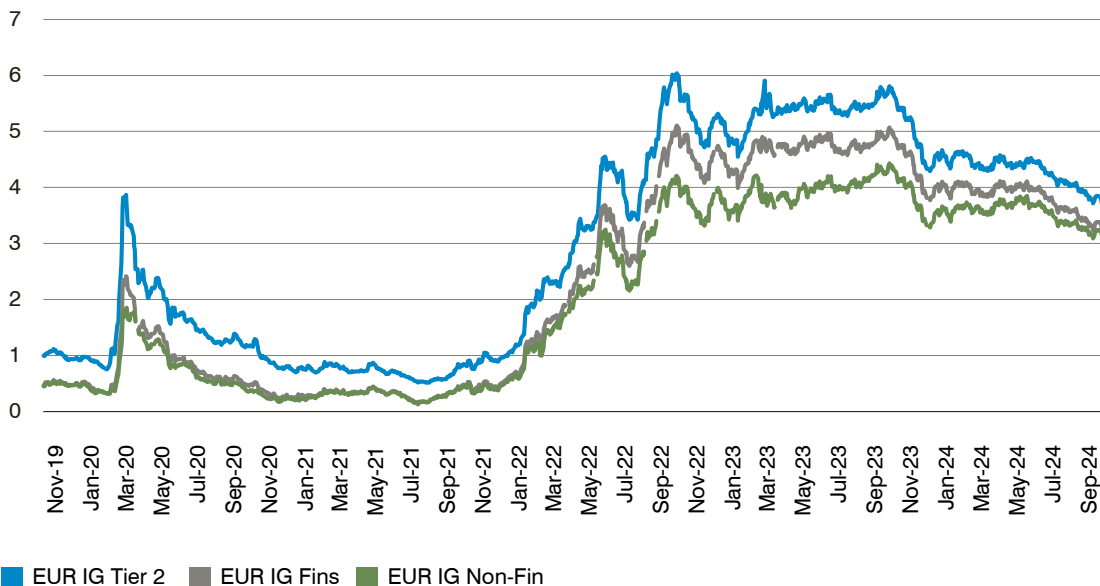
■ Annualized Earnings Buffer (PBT) - EUR bn ■ Capital Buffer (Excess CET1) - EUR bn

Source: Atlanticomnium and Bloomberg, October 2024. Past and current trends should not be relied upon as an indicator of future trends. The views are those of the manager and are subject to change.

Chart 2 illustrates the aggregate earnings buffer, which represents the amount of profit before tax from the European banking sector over the past few years. This buffer serves as the first line of defence for bondholders, protecting them from losses. On average, this buffer has more than doubled from around EUR 100 billion to nearly EUR 250 billion, providing an additional EUR 150 billion to protect bondholders. Additionally, the sector has accumulated a further EUR 250 billion in excess Common Equity Tier 1 (CET1) capital to reach more than EUR 500 billion, further strengthening the position of bondholders in the European financial sector.

Turning to valuations, the spreads on dollar-denominated additional tier 1 (AT1) contingent convertible bonds (Cocos) remain relatively attractive compared to the strong fundamentals of the sector. Currently, spreads are around 310 basis points (bps). However, credit markets tend to be cyclical. For instance, following the Credit Suisse (CS) event, spreads were at 500 to 600 bps or more. Now, we are towards the lower end of the range. In 2021, early 2020, and early 2018, the low point for spreads was around 270 bps. Given this, we believe some caution is warranted.

Chart 3: EUR IG financials still offer attractive yields compared to non-financials



■ EUR IG Tier 2 ■ EUR IG Fins ■ EUR IG Non-Fin

Source: Atlanticomnium, GAM, Bloomberg, as at September 2024. Past and current trends should not be relied upon as an indicator of future trends. The views expressed herein are those of the manager and are subject to change.

EUR investment-grade (IG) financials still offer attractive yields compared to non-financials. There is a nice pickup in yield and spread for the same rating and duration, especially on investment-grade rated Tier 2s.

Why we reduced our AT1 CoCos holdings

After the CS event, we significantly increased our holdings of AT1 CoCos, from around 15-30% to roughly 50% to 60% depending on strategies. We took advantage of extremely cheap valuations, securing double-digit yields on high quality issuers like BBVA and BNP Paribas. It was a no-brainer in our view, as we anticipated extremely attractive returns on AT1 CoCos. Now that we have experienced a huge rally and captured the majority of the upside, our strategy has shifted to a more defensive stance. Consequently, we reduced our AT1 CoCos holdings from around 50-60% to approximately 15%, reallocating mainly to Tier 2s and senior unsecured bonds.

This approach mitigates potential downside risk. Additionally, we can take advantage of potential market volatility, by reversing this strategy, switching back from seniors and Tier 2s to AT1 CoCos, and deploying some of our cash reserves as market conditions change.

Extension risk

Our favourite indicator for positioning is extension risk, as denoted in a previous article, '[Capitalising on extension risk in AT1 bonds](#)'. It looks at the percentage of AT1 CoCos priced to perpetual or call. This tends to peak around 100% when market conditions are poor and sentiment is extremely negative, as seen for example in 2016, 2020 and when Russia invaded Ukraine in 2022. Conversely, when market conditions are strong and spreads are tight, this percentage tends to approach zero, indicating that valuations are at their tightest.

For example, during Covid, the maximum drawdown for AT1 CoCos was around 30%, compared to about 10% for Tier 2s or seniors. This raises the question of whether the extra ~1-1.5% yield is worth the additional 20% potential drawdown. At this juncture, we believe it is not.

Currently, the extension risk is around 10%, suggesting that most of the upside has already been priced in and returns are becoming more asymmetric, with more downside risk than upside potential. According to this indicator, we think it is better to adopt a more conservative positioning. As said the saying goes, "History doesn't repeat itself, but it rhymes." Credit markets remain cyclical, and while spreads are tight and valuations are not particularly compelling, we can still target an attractive yield while maintaining a defensive strategy.

Romain Miginiac co-manages the Credit Opportunities and Sustainable Climate Bond strategies at GAM Investments.

For more information, please visit [GAM.com](https://www.gam.com)

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