WHAT DO RISING BOND YIELDS MEAN FOR BANKS?

Wisdomtree EU
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Since the third quarter of 2021, breakeven inflation rates for the US, UK and Germany have risen considerably. Persistent inflationary pressures tied to supply chain issues have only been exacerbated by the turmoil around Russia and Ukraine. Oil prices are near 90 dollars a barrel and any sanctions placed on Russia could push prices higher, particularly for the European Union as Russia is their largest supplier of gas. Amid this backdrop, Central Banks are much more hawkish in 2022 than last year and bond market yields are correcting to higher yield levels. The above changing variables have led to a growing demand for exposure to asset classes that provide a high income and could potentially show some resilience to rising bond yields. **One sector that has historically benefited from rising bond yields is the banking sector. In this blog, we will discuss what rising bond yields could mean for the banking sector in 2022.**

Rising long term bond yields is a credit positive for the banking sector as it can help improve bank **net interest margins (NIM)**. At a very high level, NIM is essentially the difference between the interest rate that the banks pay to depositors and what it earns on their assets such as loans made to customers. Banks will typically pay interest to customers that are below short-term rates building in a buffer to increase their profitability in a rising rate environment.

While the European Central Bank (ECB) continues to maintain a more accommodative monetary policy stance compared to the US and the UK, sustained inflationary pressures have led market participants to expect the ECB to shift towards hiking rates in the second half of 2022. While the ECB is likely to thread the needle on balancing the urge to control persistent inflationary pressures and allow the Eurozone to continue its growth trajectory in 2022, we expect the ECB’s depo rate to be near 0% by March 2023 unless exogenous factors put considerable strain on the growth trajectory for Europe. Meanwhile the German Sovereign bond curve has continued to shift higher with 10-year yields at +28 basis points compared to -18 basis points at year end 2021. That figure compares favourably to the -57 basis points yield noted at the end of 2020[1]. There is a constructive shift towards higher long term bond yields which can have a positive effect on bank NIMs.

If we consider European banks more specifically, the NextGenerationEU programme is helping to support medium to long-term growth across Europe with countries such as Italy and Spain receiving a heavy load of the loan support. Considering growth expectations for 2022, the Euro-zone is expected to slightly outpace the US with consensus data indicating +4.0% annual gross domestic product (GDP) growth compared to +3.8% in the US[2]. If the market is correct and the ECB delays any moves higher in policy rates until at least the second half of the year, loan growth for banks could see strong growth particularly ahead of any future rate hikes.

Another key area of focus for European banks will be around what will happen to the targeted longer-term refinancing operations (TLTROs) bonus rate set to expire in 2022 and the resulting impact on the European banking system. It is possible that the programme is not extended due in part to the positive impact the NextGenerationEU programme is anticipated to have on growth. European banks are positioned to indirectly benefit from the NextGenerationEU programme in particular countries such as Italy and Spain who are key beneficiaries of the programme. Banks in these regions could favourably benefit from an uptick in demand for credit. More generally, positive growth expectations for the Euro-zone in 2022 could support demand for commercial loans as companies try to cope with increased demand. This should be considered within the context of the turmoil in Ukraine and Russia which could cause further upward pressure on inflation and a subsequent slowdown in growth.

What can the earnings season tell us so far about the health of banks?

At this juncture in the current Q4 2021 earnings season focusing on the banking sector within the Euro Stoxx 600 index, we have noted nearly a 57% earnings growth in the Q4 2021 over the prior quarter[3]. So far of the 42% of companies on the Euro Stoxx 600 Index that have reported Q4 2021 earnings, the banking sector stands out by delivering thus far a 13% earnings surprise which compares favourably to the consumer discretionary sector which reported a negative 32% earnings surprise. Euro area banks fundamentals look strong, and bank regulation has led to capital ratios remaining preserved throughout the ongoing pandemic. The most recent EU wide stress tests provided assurance to investors in the Additional Tier 1 Contingent Convertible (AT1 CoCo) market that capital levels continue to maintain a buffer to regulatory requirements. The strong performance we've observed at this stage in the earnings season is likely to continue to provide support for the sector.

Conclusion

Banks continue to be an attractive sector amid the changing macro landscape and have shown resilience to the market volatility noted over the past few years. Since the onset of the pandemic[4] to 8 February 2022, bank equities delivered an annual total return of +45.4% and their subordinated debt such as Additional Tier 1 Contingent Convertibles bonds (AT1 CoCos) delivered a +13.9%[5] annual total return. Both are pockets of the bank's capital structure where an investor can also find high income. With generally strong issuer credit quality, there are opportunities for investors to look within the banks' capital structure to gain income meanwhile maintain exposure to issuers with strong credit fundamentals.

Sources

[1] Source: Bloomberg, EUR German Sovereign Curve 10 February 2022, 31 December 2021, 31 December 2020.

[2] Source: Bloomberg, economic consensus data as of 8 February 2022 using ECGDUS 22 and ECGDEU 22.

[3] Source: Bloomberg, as of 10 February 2022 (earnings season ending on 15 February 2022), Euro Stoxx 600 price index considering the SXXP using Bloomberg earnings analysis (EA) function.

[4] 16 March 2020 (trough) to 8 February 2022, European banks represented using the STOXX Europe 600 Bank index (SX7R), AT1 CoCos represented using the IBXXCCL7 index.

[5] Source: Bloomberg, period is from 16 March 2020 (trough) to 8 February 2022, European banks represented using the STOXX Europe 600 Bank index (SX7R), AT1 CoCos represented using the IBXXCCL7 index.

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