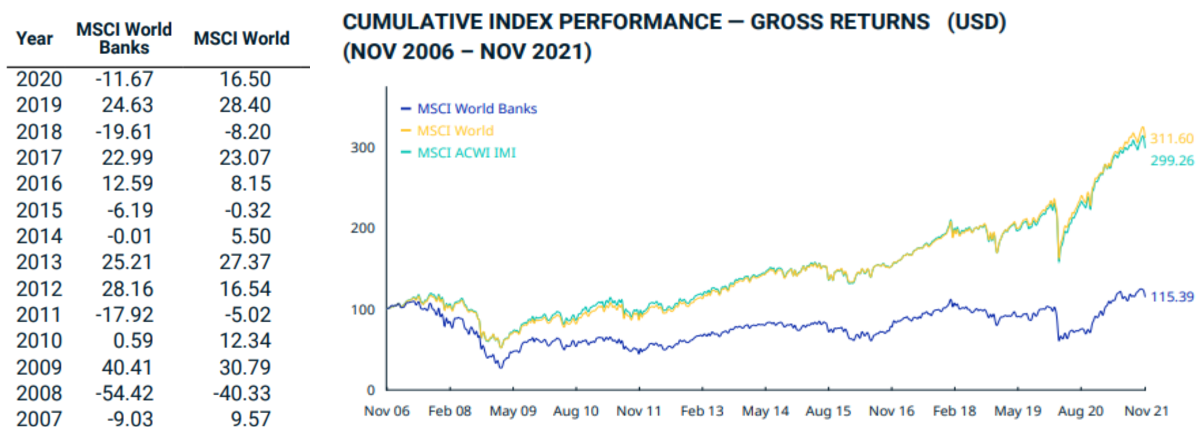
The Problem With Banks

Financials make up 13% of the MSCI All Countries Index. That fact makes them the 2nd largest sector after tech (24%). Any asset allocation decision without a view on banks is really "no decision". For investment managers therefore, banks *matter*. For many years, certainly since the Global Credit Crisis of 2009, we've counselled clients against holding developed world banks. Banks, to our way of thinking, are over-regulated companies employing vast leverage -some household names deploy 60x their share capital- to make marginal returns -the so-called "net interest margin"- to fight competitors often unfairly supported by the state, just when nimble fintech companies offer better technology. There are 4,700 banks in Europe; that's more banks than in China. Meanwhile, overpaid, greedy bank managements exact exorbitant "rents" from slow growth businesses owned by slow-witted and apathetic shareholders. Many people would prefer their daughter married a baker than a banker. Finally, Mr Market has made his own judgement: equity market returns have been three times those of banks since 2006, see below:



Year	MSCI World Banks	MSCI World
2020	-11.67	16.50
2019	24.63	28.40
2018	-19.61	-8.20
2017	22.99	23.07
2016	12.59	8.15
2015	-6.19	-0.32
2014	-0.01	5.50
2013	25.21	27.37
2012	28.16	16.54
2011	-17.92	-5.02
2010	0.59	12.34
2009	40.41	30.79
2008	-54.42	-40.33
2007	-9.03	9.57

So we listened carefully to the JP Morgan bank analyst this week when he told us that banks have the highest correlation of all sectors to higher long term interest rates (banks borrow short and lend long, so make greater profits when rates rise). And that every +0.25% increase in interest rates pushes bank profits up by +7%, on average. And that credit provisions will remain low until 2026. And that IFRS 9 accounting standards mean that European banks must now accelerate provisions, so skeleton-in-the-closet losses -a reason to distrust European banks- are now out in the open.

Where European banks fall down, JP Morgan said, is in their lack of a proper securitized market for debt. Securitization in the USA permits US banks to get mortgage loans off their books and to free up capital and get lending again (solving the monetary "velocity" conundrum). Having said that, many European banks trade on half of book value and 8-10x PERs, whereas comparable US competitors trade on 0.9-2.0x book and double the PER.

All in all, more severe European regulation than in the USA is not a killjoy for European banks. Other financial sectors -insurance, asset management, fintech- may offer more spice. And banks today are more like utility companies than growth vehicles. But the change in the interest rate cycle means that the world is changing for banks.

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