RIVERFRONT INVESTMENT GROUP

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THE WEEKLY VIEW

Southbound and Down: Opportunities and Risks in the European Financial System

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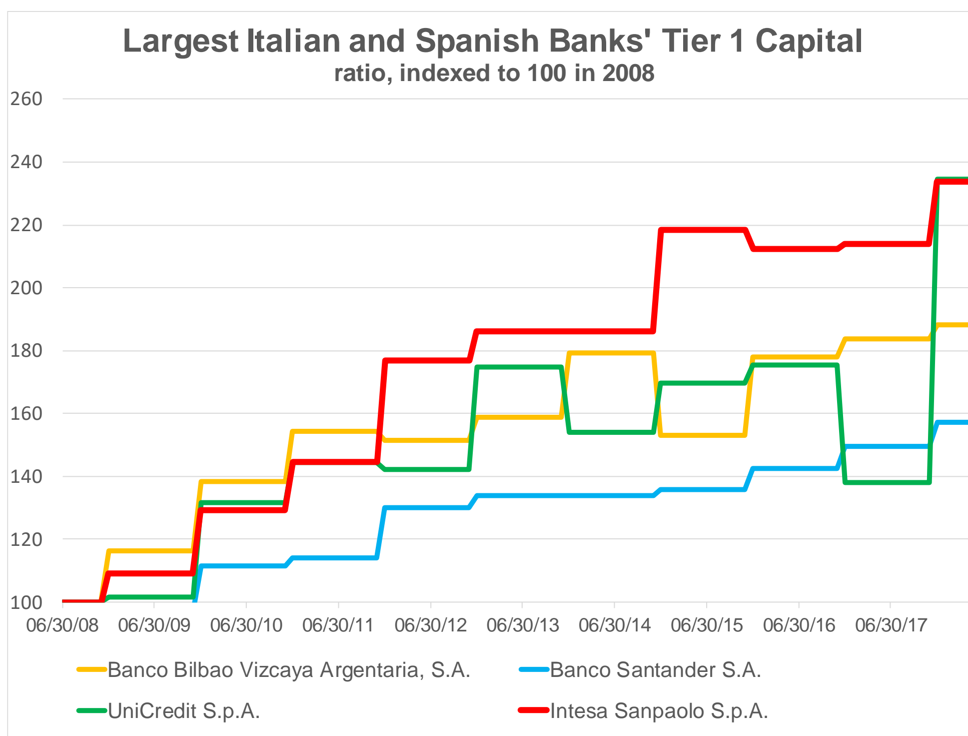
We were fortunate to spend the whole of last week abroad in Europe. In addition to lovely spring weather, we also were treated to a dizzying array of information from our meetings with executives from roughly twenty of the largest publicly-traded European banks and insurance companies. We also listened to presentations from economists and the head of sovereign ratings at a prominent rating agency, as well as regulators and policymakers from the European Central Bank (ECB), the Single Resolution Board (SRB), the European Commission (EC), European Parliament, the German Ministry of Finance, and other such alphabet soup. The goal of our trip was to walk away with a deeper 'on the ground' sense of how the recent political uncertainty in southern Europe was affecting local economies and bank fundamentals, as well as to assess the overall health of the European banking system after years of turmoil.

Our trip couldn't have been more timely, coming towards the end of a quarter marked by fears of European sovereign risk, slowing economic growth and trade wars. As 'Ground Zero' for sovereign distress, Euro financials are now trading at 20% below accounting book value; this represents close to a 70% discount to U.S. financials, despite a 280 basis point dividend yield advantage, as Euro financials yield over 4% (see *Chart of the Week*, page 3). **We see attractive opportunities in select European financials. We prefer large financial institutions in the south of Europe, which are out of favor due to political uncertainty but fundamentally improving, in our view**.

SPANISH AND ITALIAN LARGE-CAP BANKS ARE WELL-CAPITALIZED AND EXECUTING SOLIDLY

Large Spanish and Italian banks have been executing well in recent times, despite political headlines. In the last two reported quarters, the largest banks in both Spain and Italy have generally produced positive results. We credit this to improving loan demand and reduced provisioning requirements after years of forced capital strengthening by regulators.

For those concerned about contagion risk, we find it encouraging that these banks' Tier 1 capital weighting (a measure of a bank's financial strength and protection against unexpected losses) is sitting at decade-highs, having improved dramatically and steadily since the global financial crisis (see chart to the right).



Data source: Factset Data Systems, data as of 6/15/18. Past Performance is no guarantee of future results. Shown for illustrative purposes only.

Perhaps paradoxically for a highly indebted country with the most uncertain political backdrop, we find the largest Italian banks to have the best fundamental momentum of

any of the Eurozone geographies, in our view. The three largest Italian financial companies we interacted with last week – in aggregate representing roughly a quarter of the entire Italian stock index - all beat earnings-per-share estimates in each of the last two quarters, have experienced positive earnings revisions looking out to fiscal 2019, and two of the three have grown dividend payments year-over-year (source: *Factset Data Systems*). Spanish banks, like their Italian peers, have significantly improved their capital structure, but have been slightly less consistent in execution and containing costs. It is worth noting that the credit quality of Italian financials improves as one moves up the market capitalization spectrum. This suggests to us that, while many small Italian community banks still need to be rationalized, they don't possess the type of systemic risk that can take down Italy's economy or stock market, in our opinion. This is a different dynamic than in a country like Germany, where arguably their most problematic banks are their largest public institutions. The 'Landesbanken', which represent the majority of the German banking industry, are smaller and higher quality but not publicly traded.

Away from traditional banking, fundamentals have also improved for European insurers. Aging demographics, a firming pricing backdrop, M&A opportunities and more-than-adequate solvency presents a very attractive total return profile, in our opinion.

FUNDAMENTAL BACKDROP REMAINS POSITIVE DESPITE POLITICAL UNCERTAINTY

Italian executives and European policymakers admitted that while not ideal, the economy has not been negatively impacted by the political uncertainty. To quote an executive with one of the largest banks in Italy: "*We don't see any panic in the system… Italians are very used to having short-lived governments and uncertainty."* Many Italian executives also privately expressed their belief that the current coalition in Italy would govern more temperately than they campaigned, similar to the experience with Euroskeptic governments in Portugal and Greece. Additionally, many think that the current coalition will be short-lived due to incompatible core beliefs.

While the economy has remained resilient, widening credit spreads in Italy are a concern for markets (see our *Weekly View* from June 5 for our thoughts on this). On this issue, we were encouraged from a couple comments we heard last week. First, Italian bank executives have generally baked higher funding costs into their projections for this year, already anticipating spread widening. In fact, one Italian banking exec stated that they have been contingency planning for wider credit spreads for the past six quarters. Second, Italian bankers representing the country's largest financial institutions pointed out a few of the positives from widening spreads most notably the fact that they could more effectively compete against their smaller rivals. Finally, bank credit quality continues to improve as banks are able to package non-performing loans (NPLs) and sell them to investors. This is important as southern banks (particularly in Italy) still have a higher percentage of non-performing loans than optimal. Executives mentioned that market demand for buying these packaged loans has not been impacted by the political instability.

NORTHERN EUROPE BANKS STILL STRUGGLING, TOP-LINE ENVIRONMENT TOUGH

Not everything we saw or heard was positive. In contrast with the southern European banks, we were less impressed with the progress made by northern Europe's largest banks. In areas like Germany and France, the largest of diversified financials continue to suffer from undercapitalization, low interest rates, poor cost controls, lack of strategic focus, and capital markets trading businesses in secular decline. In the UK, concerns over the impact of Brexit and intense competition for retail and mortgage deposits continues to be a limiting factor.

It's also worth mentioning that Europe's long-awaited deposit insurance proposal– a pan-European FDIC-like insurance for banking deposits, is still on the drawing board after pushback from northern European politicans and policymakers. While most believe it will eventally be enacted, it is generally recognized that a final resolution is multiple years away. One head of an important German banking association neatly summed up the issue with the following quote: *"Germany is generally supportive (of the concept of pan-European deposit insurance) but it requires a health check and entry requirements."* His point was that Germans will need to feel that the vetting process in allowing banks entry must be rigorous and ongoing.

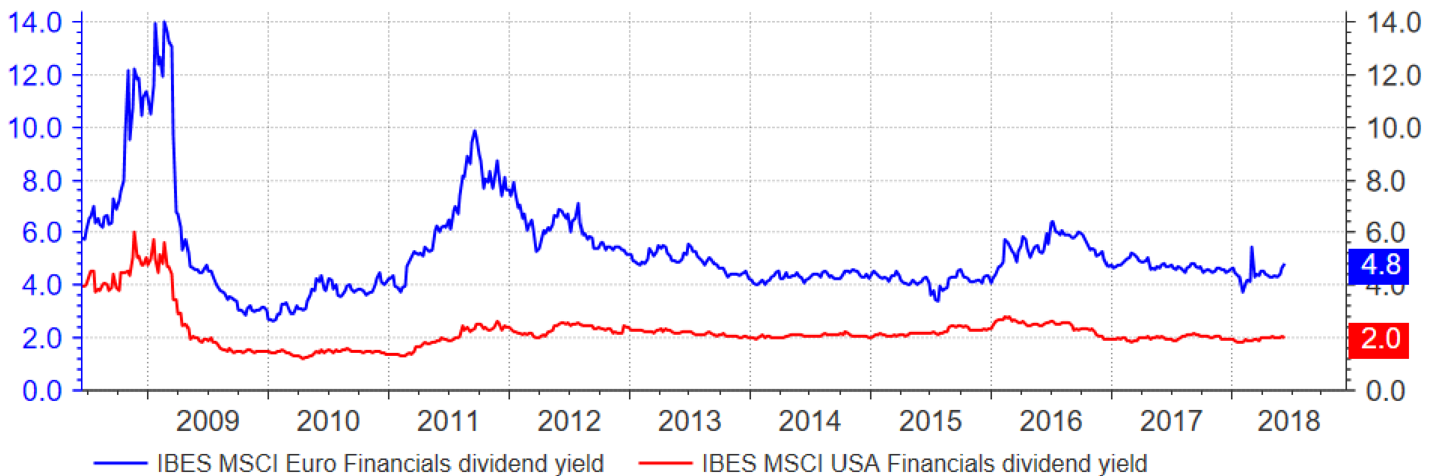
BOTTOM LINE: POTENTIAL FOR CAPITAL RETURN IMPROVING; INSURANCE COMPANIES BEST

Our strategic view is that large-cap European banks are approximately where their U.S. counterparts stood 4 years ago – regulation is onerous but now well-understood, credit quality has improved dramatically, capital return to shareholders is now squarely in focus, the European economy is expanding and, given recent commentary, the ECB is likely to start raising rates within a year or so, making basic banking functions more profitable. The *Chart of the*

Week, below, illustrates the large price-to-book value discount that European financials trade at relative to U.S. banks, as well as the relatively high dividend yields attainable in Europe. This is not to slight U.S. financials, an area we remain constructive on; rather, we simply wanted to highlight the relative value available for contrarian-minded, value-conscious investors.

In our portfolios, we recognize that the technical picture for European banks is clearly negative.This may mean that it could get worse before it gets better. In our asset allocation portfolios, we have chosen to be very selective in our Euro bank and insurance purchases and have attained exposure primarily through a combination of the largest Italian financials, as well as high quality global financial service franchises.

CHART OF THE WEEK: EUROZONE FINANCIALS TRADE NEAR 70% DISCOUNT RELATIVE TO U.S. COUNTERPARTS, DESPITE EUROPE'S BIG DIVIDEND YIELD ADVANTAGE



Source: Thomson Reuters Datastream, I/B/E/S, RiverFront; data as of 6/8/18

Past Performance is no guarantee of future results. Shown for illustrative purposes only.

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