



MARCH 2020

Global Banks Update

Challenging Decade for the Global Banking Industry

The global banking industry has faced a difficult operating backdrop for the last decade amid a challenging interest rate environment (see U.S. yield chart below), economic growth concerns, and a hangover from the financial crisis as it has been building capital and dealing with increased regulation. The industry has been one of the worst performers over the last decade, although it has experienced several periods of stronger performance over shorter interim periods, such as 2012/13 and late 2016 as valuations became significantly discounted and interest rates bottomed.



Source: FactSet Bloomberg Barclays U.S. Government Bond Index, 8/15/2000 to 3/20/2020.

Down over 39% for the year through March 18, banks have been one of the worst performers this year, only behind oil & gas, hotel & restaurants and aerospace among the industries that account for at least 1% of the MSCI ACWI.¹ Investor negativity has increased due to a variety of concerns: negative interest rates in Europe and Japan, the U.S. Federal Reserve lowering the federal funds rate target to the 0%-to-0.25% range on March 15, a likely global recession caused by COVID-19 and the expected credit losses that would likely occur during a recession.

MSCI ACWI Industry	% Weight	YTD % Changes	One Year % Change	Three Year % Change	Five Year % Change	Ten Year % Change	Dividend Yield	Price to Book Value	Forward Price/Earnings
Oil Gas & Consumables	3.03	-56.32	-57.31	-50.08	-50.60	-47.58	5.87	1.07	10.81
Aerospace & Defense	1.41	-45.22	-39.88	-17.15	0.03	106.63	2.06	5.94	17.25
Hotels Restaurants & Leisure	1.24	-44.72	-37.04	-19.30	-8.58	90.89	2.48	6.69	19.00
Banks	7.33	-39.69	-35.05	-31.05	-22.53	-6.90	4.67	0.93	8.70
Insurance	3.28	-38.13	-31.02	-20.10	-11.04	45.89	3.49	1.30	10.44

Source: FactSet. MSCI ACWI Index for periods ending 03/18/2020.

Impact of Lower/Zero/Negative Interest Rates

Banks' fundamental business is earning a spread on their capital (or NIM – Net Interest Margin) so a decrease in interest rates to zero (or negative) is a headwind to banks' fundamental earning structure (and has been for most of the last decade). However, each bank has varying sensitivities to changes in interest rates. For example, among large-cap U.S. banks today, some banks are much more sensitive to interest rate changes than others given varying traditional lending exposures. Given this difference in sensitivity, fundamental analysis is paramount when we are evaluating the effects and potential investment opportunities.

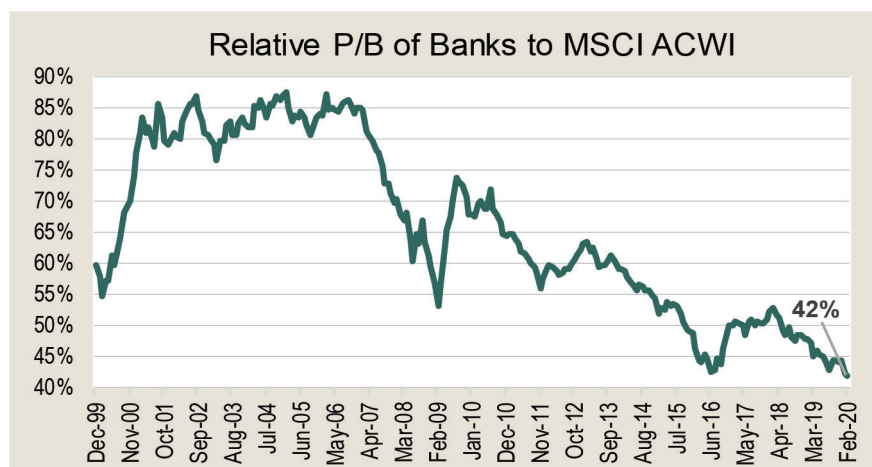
Additionally, as interest rates were already low globally, we believe the Fed's recent rate cut will not have as significant an impact on banks' earnings as the last interest rate decline period during the global financial crisis. Two main factors contribute to this: 1) the cut is less significant and there is less room for rates to move down; 2) banks have been adapting to low interest rates over the past decade and many have improved their cost structures and capital positions significantly. Finally, while this environment of low/zero/negative rates may persist for some time, the next significant move in rates is more likely to be to the upside (although that may seem like a long way away) given where we are today. If that happens, just like we saw briefly in 2013 and 2016, it would be a nice tailwind for banks' earnings. In the meantime, banks are generally trading at attractive multiples of their reduced earnings that largely account for this negative scenario continuing into perpetuity, and offer attractive return potential just through earnings and dividends if this environment does continue (and much greater potential if rates ever increase or are expected to increase).

The concerns/negativity associated with a global recession, increased credit losses, and lower interest rates along with recent significant underperformance has likely led to many investors avoiding the banks industry given the significant near-term headwinds. As a result, valuations of several banks have started to reach levels that reflect significant pessimism, potentially creating very attractive long-term investments as the negativity is already priced in, and any positive news/change could greatly benefit the banks (whether that be a rebound in growth, interest rates, lower than expected credit losses etc.).

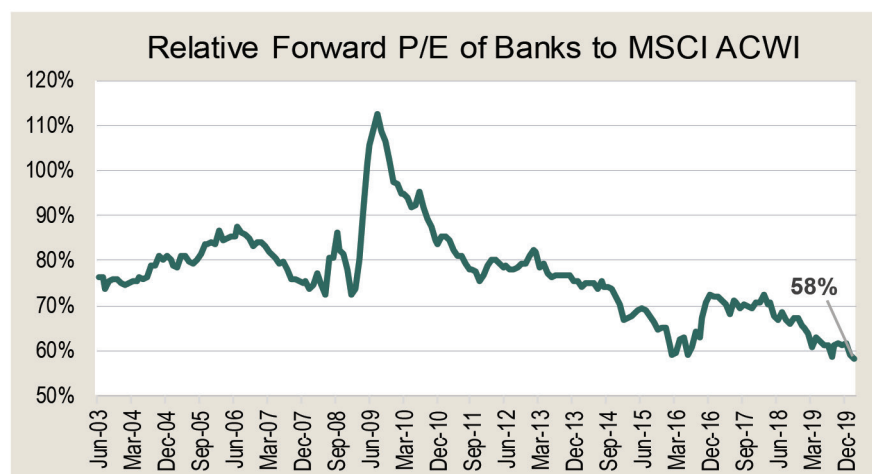
As long-term-focused investors, we have found value in several banks with a strong focus on capital levels, both in the U.S. and abroad, including emerging markets. The market's short-term focus on likely difficult near-term business results creates an opportunity for our price-disciplined and long-term focus at today's valuation levels. This is especially true in the United States as the large money center banks have much improved capital positions in comparison to the last recession and financial crisis of 12 years ago. In Europe, many have improved their capital positions as well, although not to the same extent, so we have been more selective there. Nonetheless, many European banks are currently priced at the lowest valuation levels in the last twenty years, outside of the financial crisis.

Putting the Current Negativity into Context

- *Price-to-Book (P/B)* – Banks now trade at just 92% of book value and are the cheapest industry in the entire MSCI ACWI index, just ahead of automobiles and oil & gas. The discount vs. the index is the largest it has ever been at 58% (vs. 45% during the tech bubble, 47% during the financial crisis, and 44% during the Euro crisis).²
- *Forward Price/Earnings* – Global banks are the second cheapest major industry in the index (behind autos). At less than 9x forward earnings, the industry trades at its largest discount ever relative to the overall index (42% discount).³
- *Dividend Yield* – Within the MSCI ACWI Index, the banking industry has the fourth highest dividend yield (over 4.5%), only behind tobacco, oil & gas, and telecommunication services.⁴ Obviously, as with oil companies, there is a risk that dividends could be cut amid an increasingly recessionary environment (currently stock buybacks of U.S. banks have been paused), but given the capital improvement, we believe the risk and potential magnitude of any dividend cut is lower than it has been during past recessions. Additionally, the current gap between banks and the broader index of over 2% is near the highest it has been in the last 20 years.⁵
- The yield on U.S. banks is a bit lower at 3.4% as more of their capital return (about two-thirds) has been through stock buybacks, which have been halted during this current period in order to preserve capital.⁶ Since U.S. banks have had more capital return through share repurchases, we believe they bear lower risk for potential dividend cuts during this period. U.S. banks' dividend yield is over 70% higher than the broader U.S. dividend yield of just 2.0%.⁷



Source: MSCI via FactSet. 12/31/1999 to 02/29/2020.

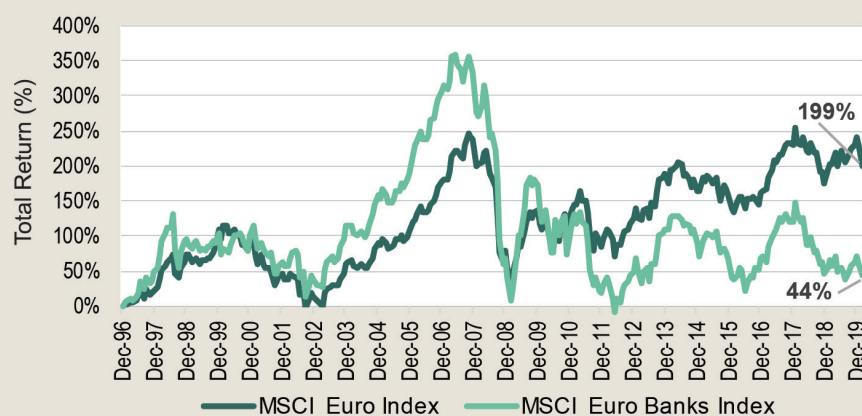


Source: MSCI via FactSet. 06/30/2003 to 02/29/2020.

Interesting Notes from Recent Sell-Side Pieces and Articles

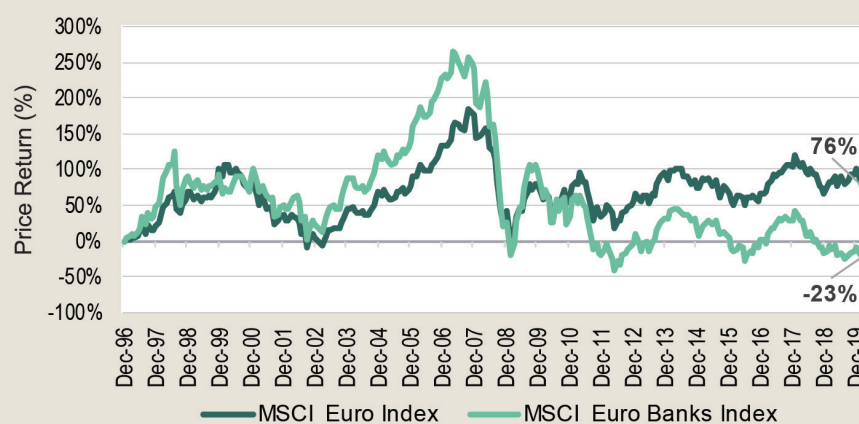
- U.S. banks in the S&P 500 Index now trade at below long-term average multiples on depressed earnings estimates that have been cut in half as a normal recession seems to be priced in.⁸ U.S. banks are also trading below their 2011 and 2016 valuation lows on a price-to-tangible book basis, but not all the way down to financial crisis levels.⁹
- U.S. banks have an improved capital position and much improved ability to handle a recession and credit losses than 12 years ago. Last year, the 18 largest U.S. banks all passed stress tests which included a hypothetical recession with unemployment to 10%, gross domestic product down 8%, and stocks down 50% (losses reached \$410bn, so less than half of their capital positions).^{10 11}
- European Banks within the MSCI Euro Index: Are down to 6x earnings and 8% dividend yield (as of 3/11/2020) and the implied cost of equity for many Eurozone banks is 15-20% at current valuation levels.¹²

Eurozone Banks Have Underperformed the Broader Eurozone Market over the Past Decade



Source: MSCI via FactSet. 12/31/1996 to 02/29/2020. Total return since first available date.

Price Return %



Source: MSCI via FactSet. 12/31/1996 to 02/29/2020. Price return since first available date.

Brandes' Current Bank Holdings and Activity

The bottom line is that near-term earnings are likely to be negatively impacted by increased provisioning and NIM compression, but we believe dilution risk is relatively low for most of the banks we own barring a more severe economic/financial shock.

This will be a very interesting and crucial test of the decade-plus of heavy regulation of the financials. If they can get through this without dilution, we think the environment is going to be much better for them—steeper yield curves, probably decent loan growth. We will see if the capital buffers do their job. So far, it appears the central banks are supporting them to the max. Forbearance seems to be the word of the day as well. If banks perform as intended through this crisis, it could lead to a paradigm shift in how the sector is viewed going forward.

¹ Source: MSCI via FactSet as of 3/18/2020.

² Source: MSCI via FactSet. For the period 12/31/1999 to 02/29/2020. P/B as of 02/29/2000 for tech bubble, 02/27/2009 for financial crisis, and 11/30/2011 for euro crisis.

³ Source: MSCI via FactSet. For the period 06/30/2003 to 02/29/2020, and as of 02/29/2020.

⁴ Source: MSCI via FactSet. As of 02/29/2020.

⁵ Source: MSCI via FactSet. As of 02/29/2020.

⁶ Source: MSCI via FactSet. U.S. banks in the MSCI USA Index as of 02/29/2020.

⁷ Source: MSCI via FactSet. U.S. banks in the MSCI USA Index as of 02/29/2020.

⁹ Autonomous Research, "US BANKS: Zero Dark Stormy" March 16, 2020.

⁸ Autonomous Research, "US BANKS: Zero Dark Stormy" March 16, 2020.

¹⁰ CNBC, March 17, 2020.

¹¹ Bloomberg.com, March 18, 2020.

¹² UBS, "European Banks: COVID-19 concerns take Eurozone banks to 6.0x EPS, 8% yield: Here's what we think happens next" March 11, 2020.

Federal Funds Rate: The interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution

Forward Price/Earnings: Price per share divided by earnings per share expected over the next 12 months.

Net Interest Margin: Interest income generated by a financial institution minus the amount of interest paid to its lenders, divided by average earning assets.

Price/Book: Price per share divided by book value per share.

Price/Earnings: Price per share divided by earnings per share.

Tangible Book Value: Book value minus intangible assets (e.g., goodwill).

Yield: Annual income from the investment (dividend, interest, etc.) divided by the current market price of the investment.

The Bloomberg Barclays U.S. Government Bond Index tracks performance of U.S. dollar-denominated, fixed-rate debt securities issued by U.S. government-owned or sponsored agencies. The index is a total return index which reflects the price changes and interest of each bond in the index.

The MSCI ACWI with net dividends captures large and mid cap representation of developed and emerging markets.

The MSCI USA Index with net dividends captures large and mid cap representation of the United States market.

The MSCI Euro Index with net dividends captures large cap representation of developed markets in the European Union.

The S&P 500 Index captures the largest 500 companies listed in the United States.

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