DIVAS EUROZONE

The last truly undervalued asset globally – Eurozone retail banks

Marketing material for professional investors

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Looking at current equity investments/positioning of market participants, ranging from small independent asset managers to large global financial institutions, there is a striking similarity; they are all positioned alike. Those trying to partially move away from the sprawling secular growth trade, but did not dare yet to venture into the exceptionally attractively valued large caps cyclicals, instead started last year to aggressively move into the mid-small cap space. Now a very crowded and overvalued segment that had started to underperform the value factor many months ago. With momentum gradually shifting away from secular growth to large cap cyclicals, this became the flavour of the day. A move that in view of skyrocketing leading indicators, could easily be explained to clients and, for independent asset managers, straightforward to implement with individual positions in large cap cyclicals, which is now a partially crowded space. For example, prominent representatives like ArcelorMittal and Volkswagen pref. are up four- and threefold over the last 13 months.

The last truly undervalued space globally in equities is eurozone retail banks.

Having suffered 14 years of inconceivable underperformance, outright excluded as an investment category at many investment managers, never in history have they been as attractively valued, as healthy and as overcapitalised as they are today.

The beauty is, that no-one has any meaningful exposure to this treasure.

The problem is that client psychology does not allow investment managers to gain outright exposure to banks - neither through segregated stocks (as independent asset managers tend to do) nor through passive banking ETFs as the rest of the industry would do. Above all because they have incessantly told their clients throughout the last decade, how structurally challenged and therefore uninvestable eurozone banks have become. Even the most courageous have given up long time ago, since the need for explanation towards clients for holding a bank is just unbearable.

Once this last truly undervalued asset category starts to seriously outperform, investors will get into a prisoner's dilemma. Either continue to preach the gospel the way they have done for the last 12 years and go down under for underperforming so royally (eurozone banks are still the single largest weighted sector) and losing clients in droves or give in to the pain trade to survive this earthquake and move part of their money into banks. The pain will eventually force everyone to transition. The earlier they move the lesser the pain. Since client psychology forbids them to gain outright exposure to the space, the only avenue to do so is to engage into an actively managed, bottom-up, valuation-based value fund.

Some 50-75% of eurozone retail bank's revenues are derived from net interest income, i.e., pooling client's savings and lending these savings at attractive net interest margins onto borrowers of all denomination. Historically, with steep yield curves, a hugely profitable trade. Over the last couple of years, factually flat yield curves have proved a major challenge. Put another way, core revenues of our bank's business model have been in recession for the last couple of years. The ironic thing is, that retail banks, currently suffering from depressed revenues (50-75% of revenue base on recessionary levels) are trading at depressed earnings multiples of some 7x. Banks, having cyclical business models, historically traded at some 16-18x trough earnings and some 10x peak earnings, i.e., current valuations are completely off the mark. Eurozone retail banks' loan books have an average maturity of some 6 years. A steepening yield curve implies that every low margin or loss-making loan on the back book is expiring and being refinanced into a higher margin loan on the front book, which will gradually drive net interest margins higher. This is not a 6-9 months occurrence, but a multi-year process.

Just to clarify, when we are talking about banks, we are not referring to the UBS and Credit-Suisse of this world, hybrid business models of investment banking and Wealth Management, both businesses in structural decline. We are talking about classical retail banks that

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keep accumulating surplus core tier 1 equity capital (CET1) they don't need, and will, come October 1, 2021, start returning these excess funds to shareholder in form of royal dividends (some 6.5%) and aggressive share buy-backs, to finally get rid of their enormous CET1 capital surplus, they were forced to accumulate by the regulator ever since 2009 and artificially massively depresses their reported ROEs.

With global economies in the process of overheating, before the first investments from the unprecedented global stimulus programs has even reached the real economy (the European Union is now in the process of readying the financing of the first EUR150 billion tranche of its EUR750 billion stimulus program that will flow into the economy in form of infrastructure investments starting June 2021), skyrocketing commodities (up 45%-175% over the last 12 months) will ensure that rising input costs in global economies will feed through PPIs into inflation (typically with a lag of 3 months). With most of our cyclical companies already reporting earnings exceeding pre-Covid levels and enjoying sprawling free cash flow (FCF), barbarians (union representatives) are gathering at the gates. They will definitely be asking for very generous pay hikes. Salaries constitute some 80% of core inflation.

This, combined with QE being partially disbanded with effect from July, will drive normalisation of yield curves. 5-year forward inflation expectations currently stand at some 1.6%. Even though we are highly likely to comfortably overshoot the 2% mark over the next 18 months, that number is at least in line with current inflation running at 1.6%. However, what is completely off, is the 10-year bund yield still trading at -20 basis points. Last time we had forward inflation expectations at 1.6% back in 2015, the 10-year bund yield traded at +75 basis points – mind the gap! The 10-year bund yield is at this very moment in the process of breaking the all-important technical level of -20 basis points. Should that level break, it is highly likely to unleash a buying panic in eurozone retail banks. It's the buy signal for the USD3 trillion momentum machine.

The only asset that protects you from rising inflation, spiking (normalising) interest rates and momentum assets is eurozone retail banks. We currently have some 45% exposure to financials.

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