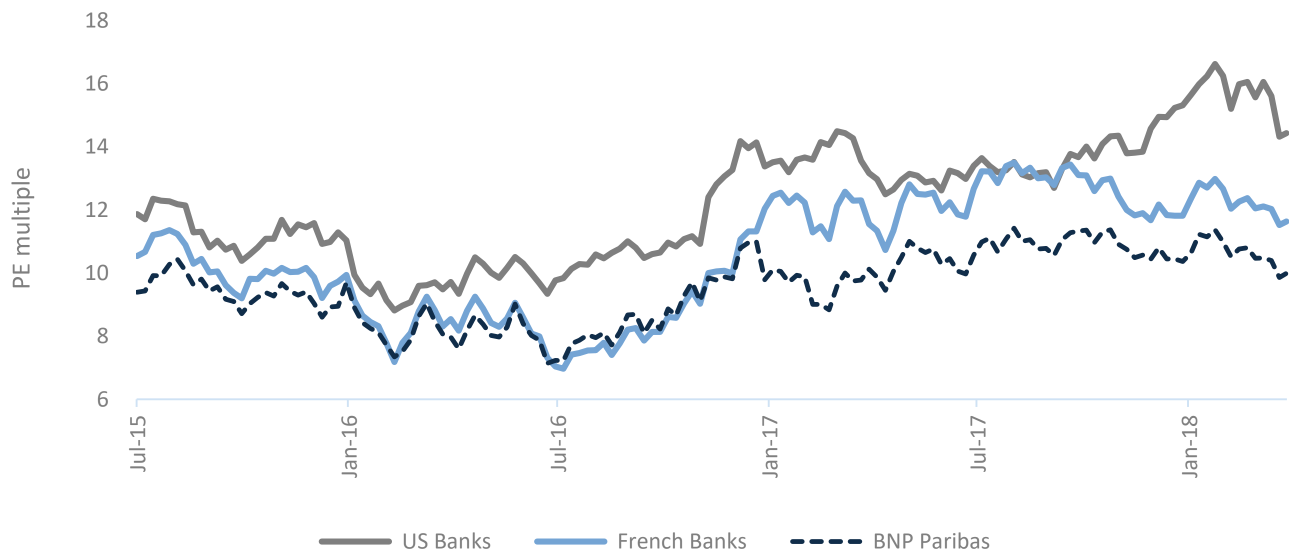
FRENCH BANKS AND MACROECONOMIC CONVERGENCE

Blake Allen
Equity Research & Strategy

At present, many important features of the global economy can be expressed through the lens of global banks. One such theme is macroeconomic convergence, evident in GDP growth rates, and the associated likelihood that global central banks will increasingly follow the Fed in a normalisation path. This note focuses on the theme of macroeconomic 'convergence' between the US and EU, and the associated opportunity presented by the 'divergence' between valuation multiples attaching to US and EU banks. In particular, we focus on BNP Paribas (BNP), the largest French bank, and some important macroeconomic developments in its home economy, the second largest in the EU. Although we do not own BNP at present, it is on our list of potential buys in Europe as we continue to monitor economic developments and reflect upon the composition of our DM exposure.

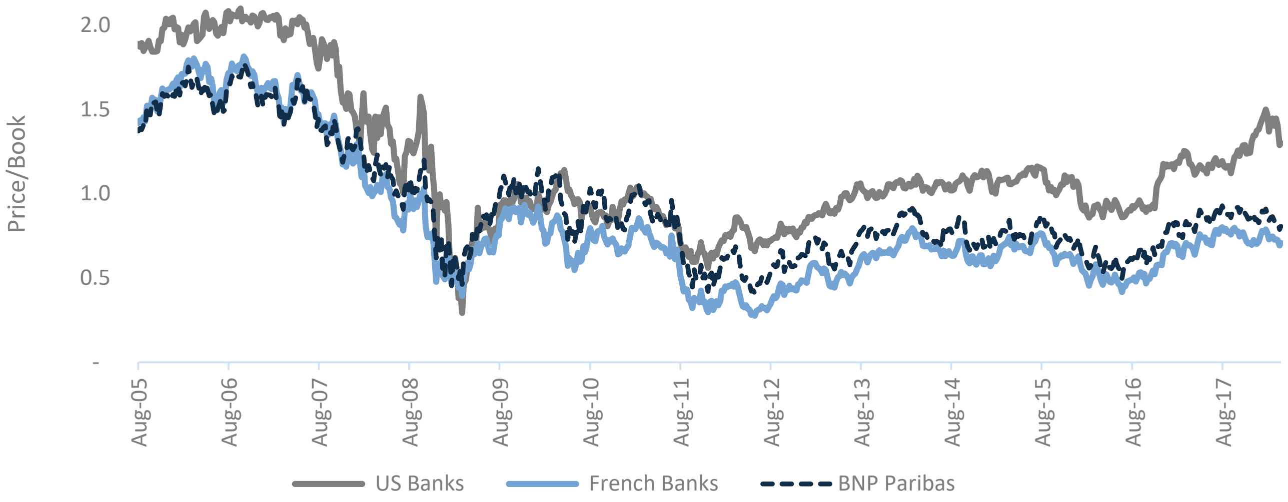
Figure 1: US and French banks' PE multiples



Source: Bloomberg; Anchor estimates; US banks = Bank of America, JP Morgan, Citi and Wells Fargo; French banks = BNP Paribas, Société Générale, Credit Agricole

Is there a genuine value-gap between EU and US banks? The PE differential between US and EU banks (*Figure 1*) is about 24% which, on the face of it, seems fair: US banks are better quality and have better growth prospects. But US banks are currently closer to peak ROEs, while EU banks are closer to a trough, which suggests that an underlying value-gap does exist. The divergence between Price/Book multiples is very wide, with US banks trading at almost double the PB multiple seen in their French peers. Prior to the global financial crisis (GFC) this differential was narrower (US banks attracted a c. 25% premium). The respective dividend-yield premiums over bond yields (*Figure 3*) also quite strikingly suggest a valuation divergence.

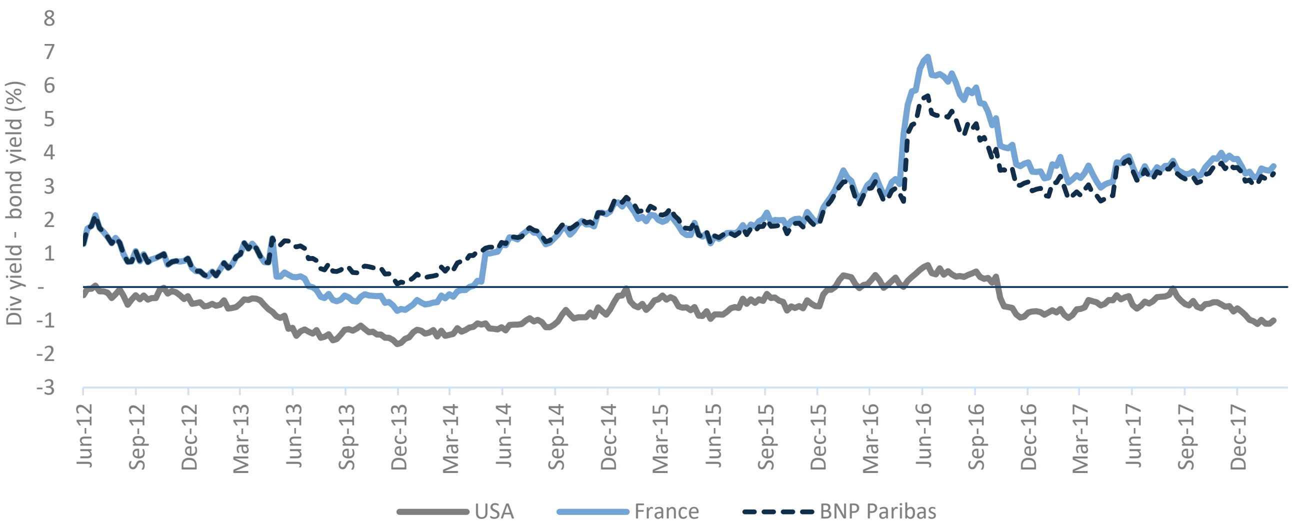
Figure 2: A widening Price/Book differential



Source: Bloomberg

Whether or not these divergences are an opportunity appears to hinge largely on whether, and to what degree, there is a normalisation of the post-GFC financial malaise in Europe. Historically, European interest rates have cycled in line with US rates, but with a 12-18 month lag (*Figure 4*). In the current cycle that lag is longer, probably about 3 years, with the European Central Bank (ECB) expected to start hiking in 2Q19. It is important to note that, with the GDP differential between the US and EU having closed (*Figure 5*), the interest rate differential is apparently far too wide. It is true that central bank policy is set with respect to the inflation outlook, not GDP levels. But real GDP is one of the best leading indicators of core CPI. Furthermore, ECB rates are still at "emergency" levels, which do not reflect the current economic reality.

Figure 3: Banks' dividend yield premiums: a very wide gap

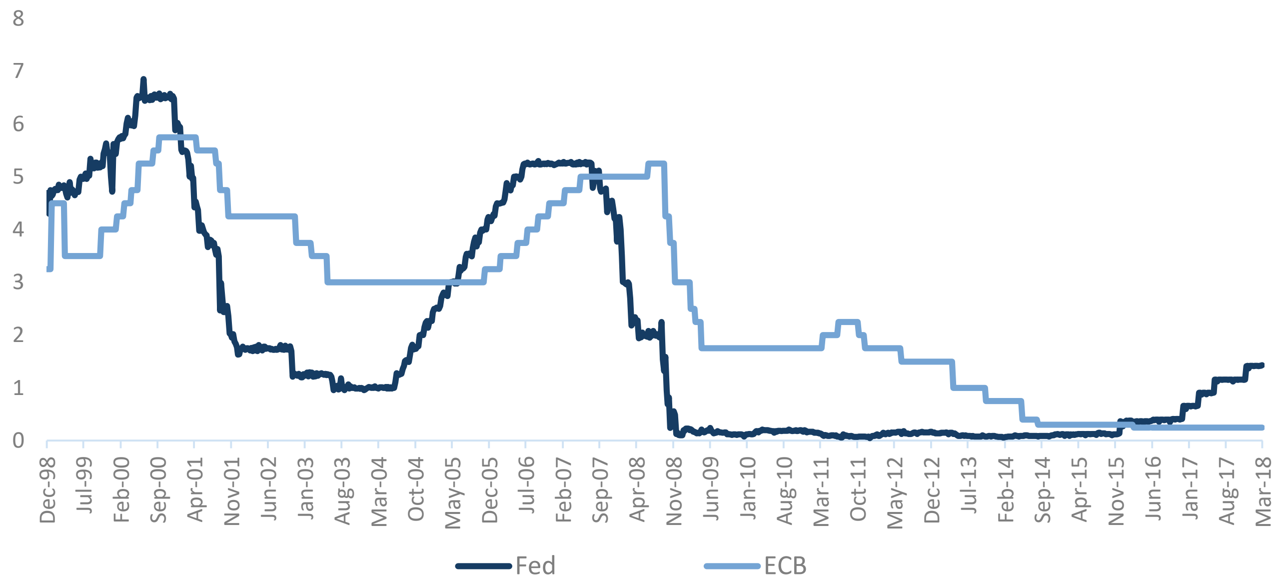


Source: Bloomberg; Anchor estimates

Quantitative easing (QE) by the ECB has been particularly dramatic, in our view, in its repression of interest rates. Consider, for example, that European firms have funded 50%-60% of new corporate issues in the US during this period.[1] These enormous flows of capital from Europe to the US, largely the result of QE, are likely to reverse with the commencement of quantitative tightening (QT) – see *Figure 6*. Similarly, we expect this development to result in a normalisation, in part or even entirely, of the interest rate divergence seen in the era of QE (*Figure 7*).

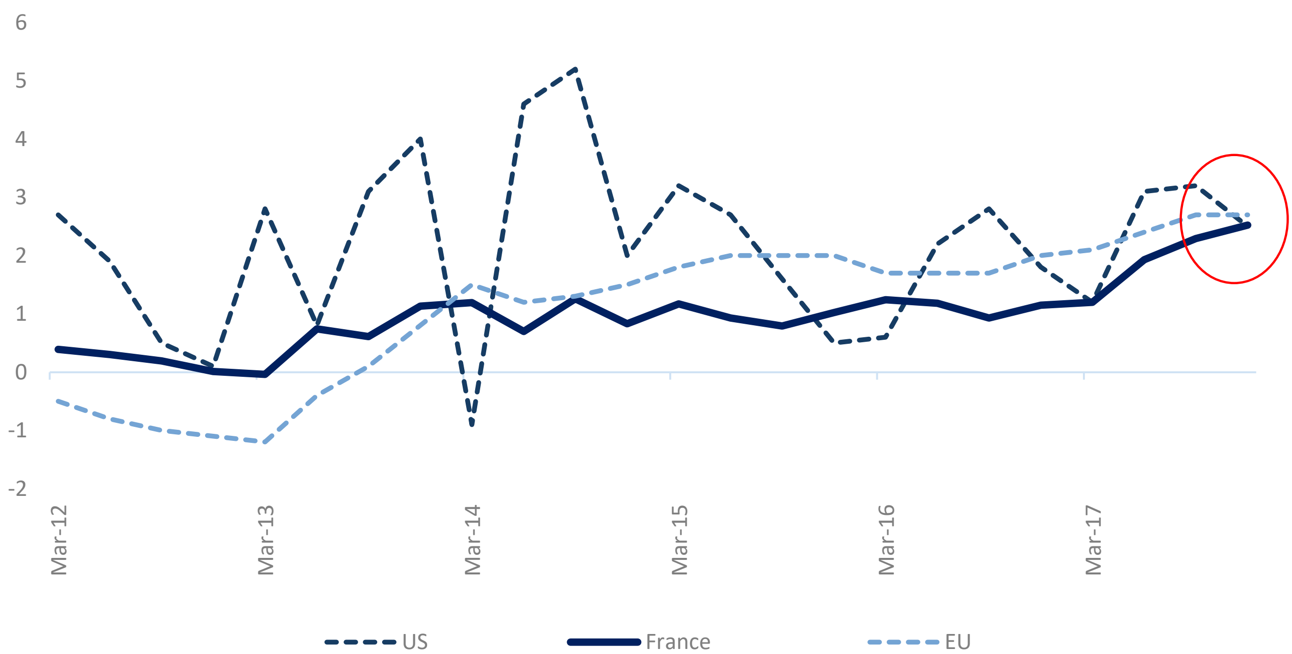
US banks have already seen most of the benefits of interest-rate normalisation. This is not to say rates won't get any higher in the US, but that new dynamics start to kick in from here (e.g. deposits need to be repriced), such that rising interest-rates yield proportionately less of a rise in bank profitability. European banks are yet to see such rate hikes and thus the corresponding benefits of normalisation are yet to flow through to them. Hence they are both "cheaper" and on the right side of expected developments in interest rate markets. In short, this suggests that we should expect the valuation differentials, noted above, to narrow.

Figure 4: Fed rates typically lead ECB rates by 12-18 months



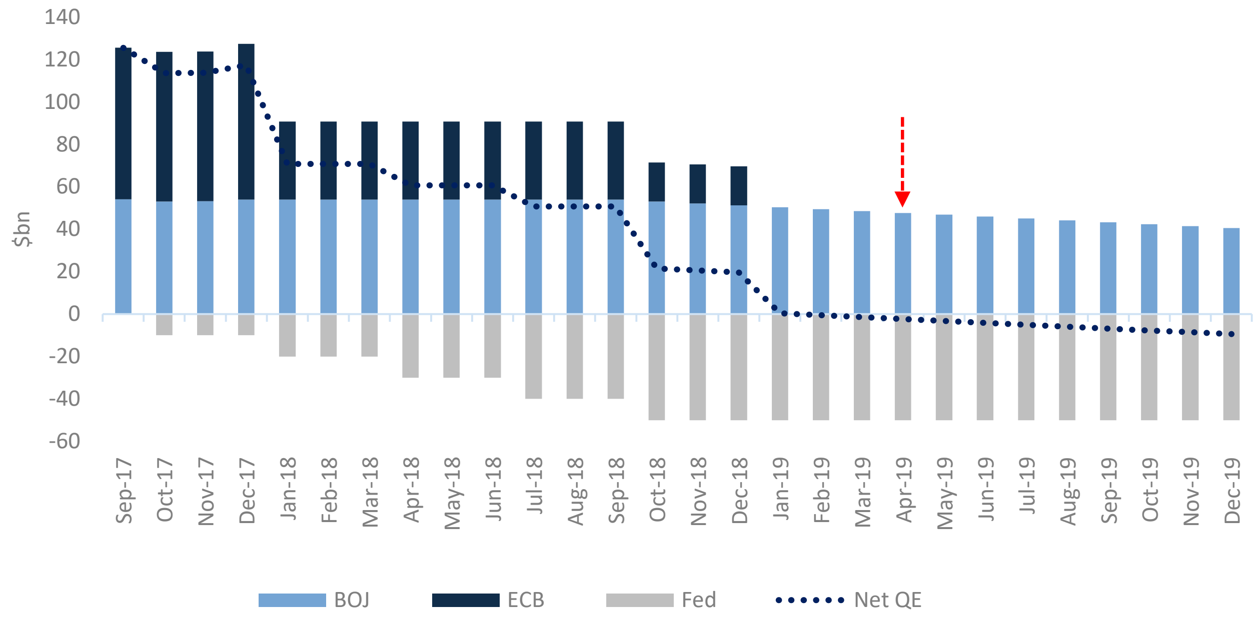
Source: Bloomberg

Figure 5: US and EU GDP have converged



Source: Bloomberg

Figure 6: Central bank bond purchases: QE to QT within the next 12 months



Source: Anchor estimates; Bloomberg

It should be noted that the unwinding of QE is not unambiguously bullish for EU banks. Indeed, at least two key risks could be noted: (1) QT is likely to strengthen the euro, lowering current account surpluses that have buoyed EU GDP, and furthermore acting as a disinflationary pressure. (2) In the QE-regime, weaker EU sovereigns have been able to issue debt at very low rates, temporarily masking their fiscal weakness. QT means that any fiscal “cracks” could start to show again.

Of the suite of opportunities available to investors at present, we think global banks deserve an overweight allocation. Many of the last decade’s extreme headwinds, are finally turning into tailwinds: interest rates, GDP growth, and inflation rates are shifting in the right direction and, while banks have struggled for years to build sufficient capital, many now have excess capital. Further, while the regulatory environment was becoming increasingly onerous and draconian in the post-GFC years, banks are now largely on top of new regulations, with the pile of GFC litigation mostly behind them. Indeed, the regulatory tide is actually turning towards deregulation – though the latter is more evident in the US than the EU.

In turning to consider the French economy, it should be borne in mind that French banks – like the members of the CAC more generally - are really global players, often more representative of the EU economy than France in isolation. But the French economy is the second largest in the EU (15% of EU GDP) and, in some ways, a microcosm of more general EU developments.

France is interesting at present because of its meaningful recovery in GDP growth, which seems to have a relatively sustainable outlook, given that unemployment is falling from quite high levels (*Figure 8*). That is, the absorption of labour slack is likely to follow a virtuous cycle for some time: better employment bolsters confidence, which allows less conservatism with respect to household savings (*Figure 9*); this in turn should boost consumer spending, GDP, and employment.

There is also a structural element to France's longer-term growth outlook, as French President Emmanuel Macron attempts to push ahead with his reform agenda. This is a thorny issue for France, and one is rightly wary of the prospects of success (note the industrial action taking place at the time of writing this report). However, it should be borne in mind that Macron was elected on a reform / pro-business agenda and such reforms are, in our view, more politically tolerable in an environment of strong GDP growth. One might note, for example, how "bad politics" like Euroscepticism tends to flare up when growth is weak, and to subside in more economically affluent environments.

Macron has already achieved some liberalisation of the labour code and cuts in taxes. In 2017, Parliament approved a progressive reduction in the corporate tax rate from 33% to 25% over the 2017-2025 period. More broadly, Macron's structural reforms are aimed at reducing France's bloated state, and reducing employment-related risks faced by companies.

Figure 7: 10-year bond yield: Will France catch up when QE ends?

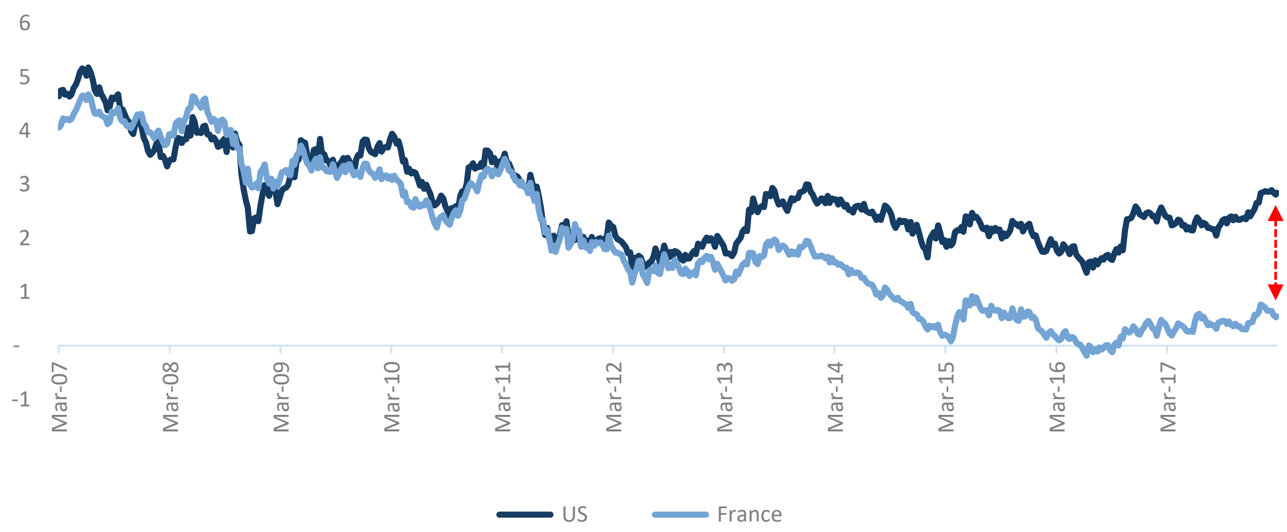
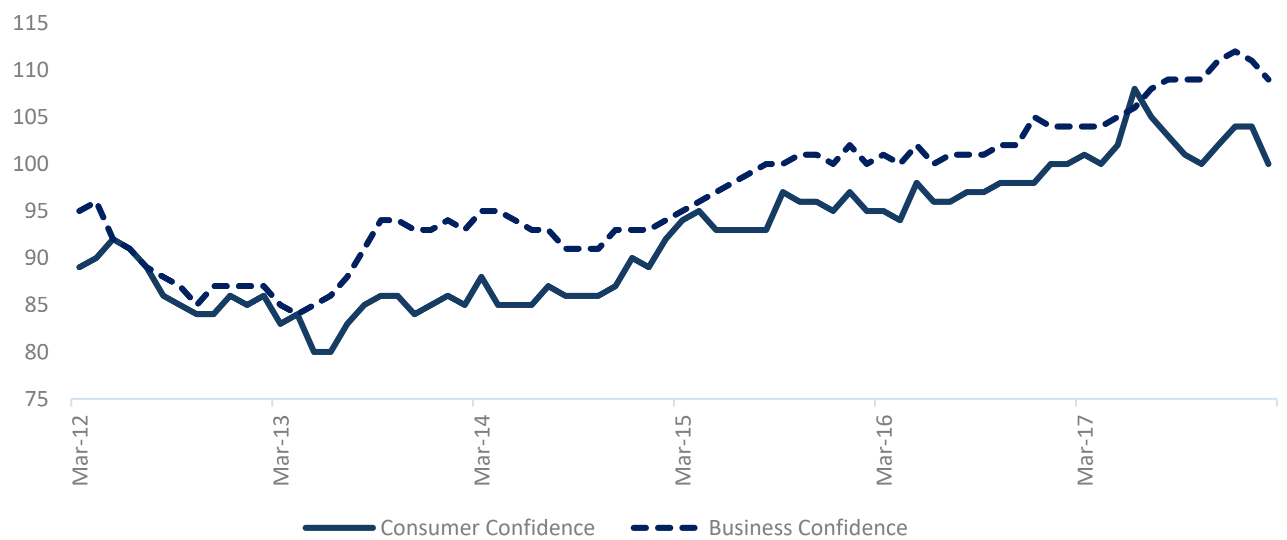
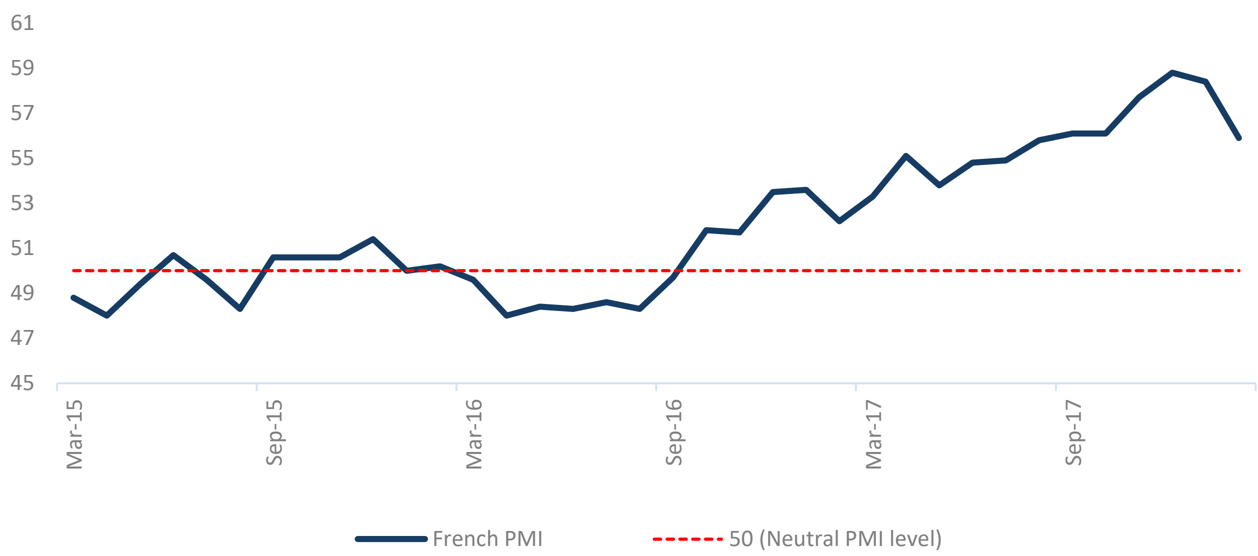


Figure 8: French business and consumer confidence still at high levels



Source: Bloomberg (Figure 7 and 8)

Figure 9: French PMI has corrected, but remains high

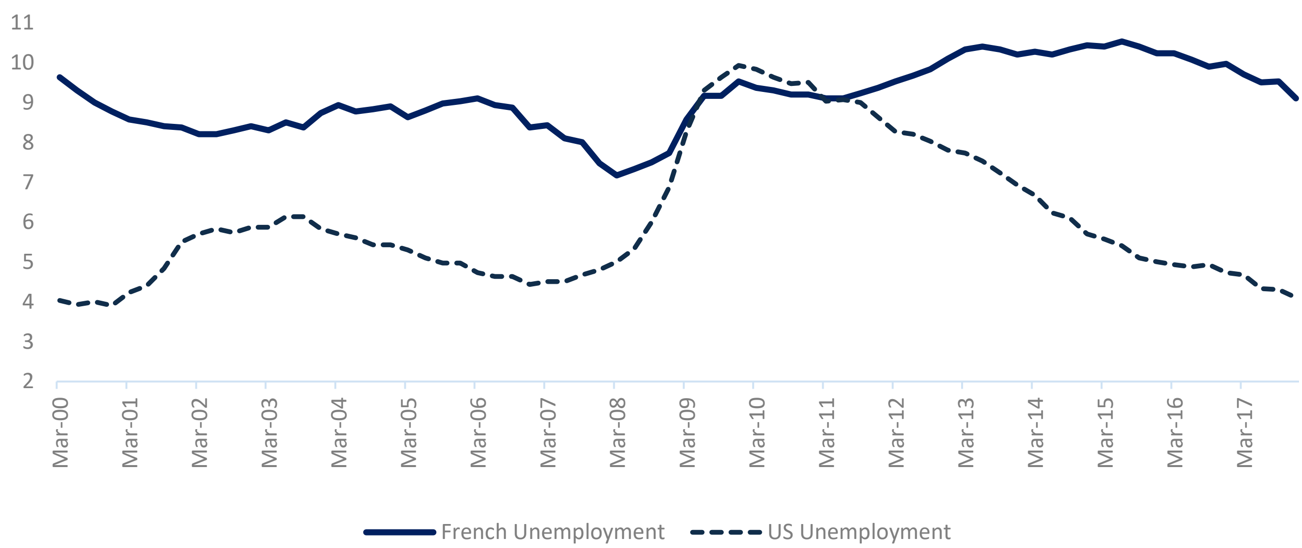


Source: Bloomberg

Macron wants France to play more of a leading role in Europe, but the country's credibility in this regard is hampered by its high fiscal deficit, which has been outside of EU limits since 2007 (the EU limits fiscal deficits to 3% of GDP). This means France faces what is called the Excessive Deficit Procedure unless it reigns in spending. France would surely need to play by the rules if it hopes to have a leading role in the EU. But cutting fiscal deficits generates a negative fiscal thrust, as GDP growth is affected by the change in deficit, more than its absolute level. While this should dampen GDP growth, there is a reasonable expectation that France will be able to reduce its deficit without causing a recession, provided GDP growth momentum remains robust.

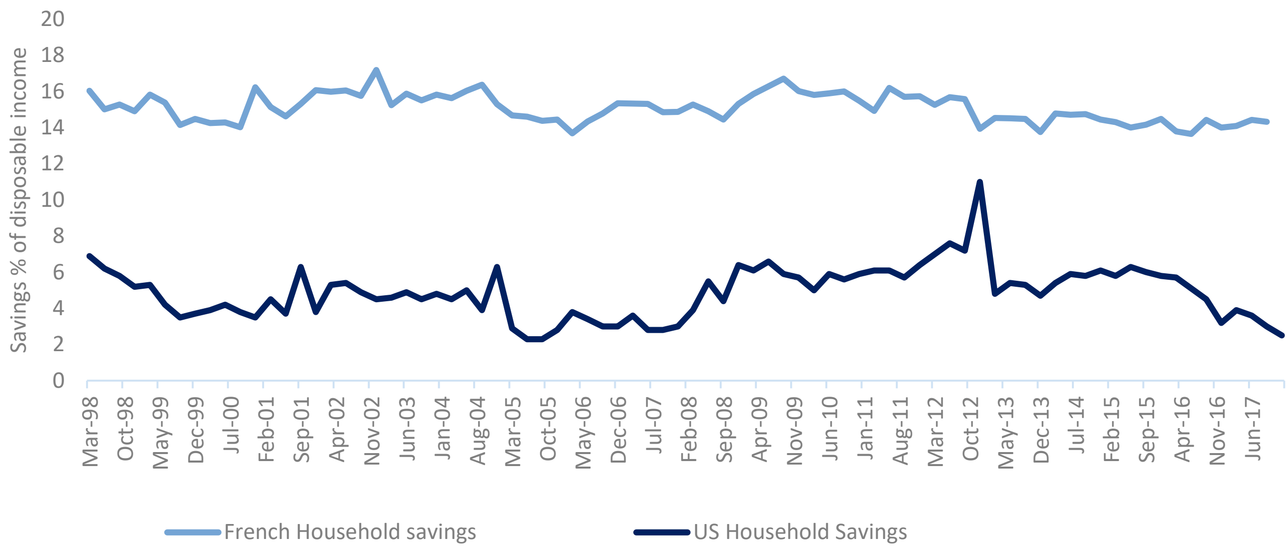
So, France's growth outlook is not straightforwardly positive. While cyclical momentum and Macron's structural reform agenda bode well for the region, it is hampered by risks associated with its fiscal deficit (the latter is, however, a quite pervasive feature of DM economies at present). In our view, the theme of French reform is, on balance, modestly attractive. In spite of the abovementioned concerns, there are reasonable prospects of some success, and the associated valuation multiples are still quite depressed. As noted, however, the value proposition for French banks is predominantly an EU-wide theme of monetary normalisation, and strong EU GDP growth. The French reform story, touched on here, is but one important component of this larger picture.

Figure 10: French unemployment – lots of slack to absorb



Source: Bloomberg

Figure 11: French household savings are relatively high



Source: Bloomberg

BNP Paribas

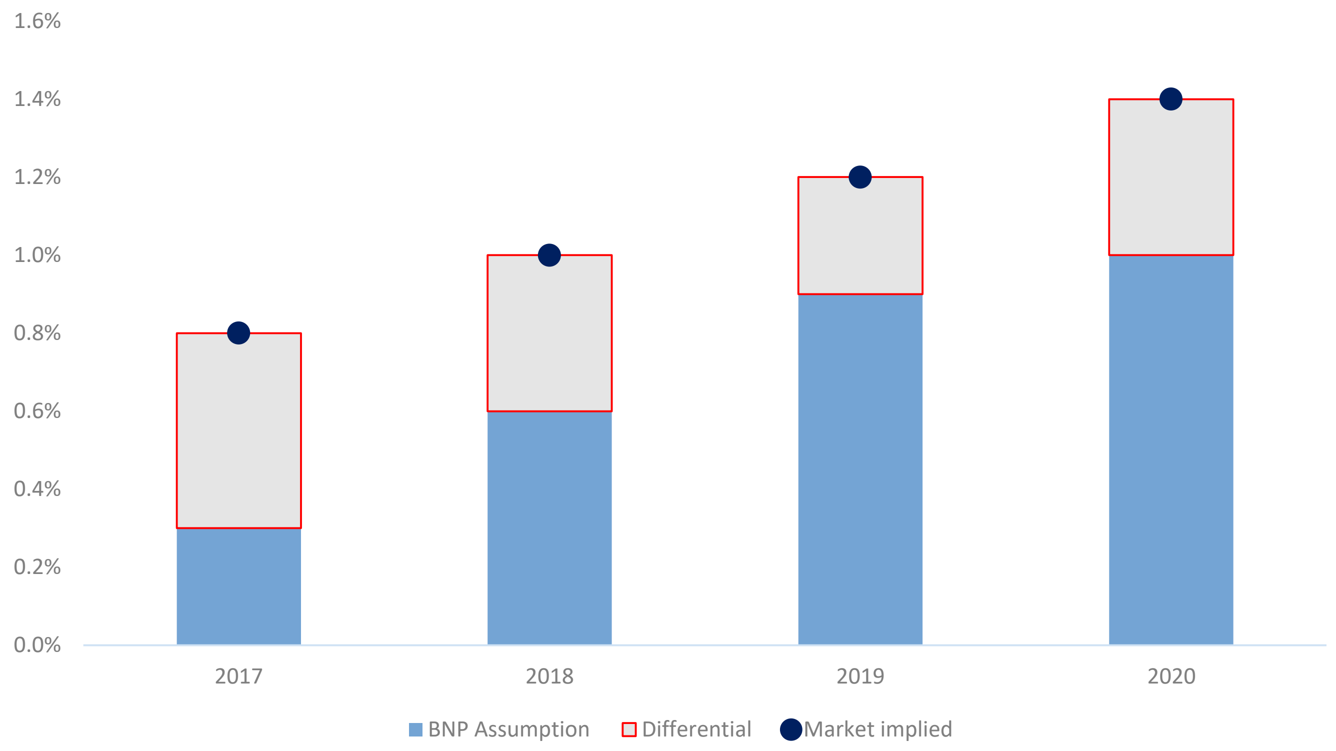
We shall now drill a little further into the details, and consider BNP Paribas, the largest French bank (EUR77bn Market Cap). Its operations are split between EU (75% of assets) and non-EU (25% of assets) geographies. This section briefly touches upon the latest financial results, the content of BNP's 2020 strategic plan, and our estimate of the fair value of the stock.

BNP's most recent results (FY17) saw net income up a modest 4.4% YoY, comprising revenue growth of 1.5% and operating cost increases of 0.5%. These numbers reflect the current low interest-rate environment, mitigated by good cost-control. The dividend increased 12% on 2016's level. These higher payout levels reflect increasing clarity on the regulatory environment, and the fact that EU banks have built up sufficient capital in terms of more demanding post-GFC regulations. In BNP's case, the CET1 ratio was at 11.8%, +30 bps on the prior year, and modestly ahead of the regulatory minimum of 11.5%.

BNP's strategic plan for 2020 includes an ROE target of ">10%". But one should ask: how far above 10% and is this representative of a 'normal', mid-cycle, environment? In our view, a normalised ROE is probably closer to 12% (although this may appear to be a small differential, it has a material effect on the fair P/B multiple estimate). BNP's ROE in 2017 was already at 9.4%, and the strategic plan includes quite meaningful cost reductions by 2020, with the cost to income ratio falling from the current 69% down to 63%. Further, there should be a tailwind from falling French tax rates, from the earnings boost due to acquisitions made in 2017 (estimated to add 1% to ROE in 2020), and from GDP growth and interest rates being somewhat higher than what has been assumed in BNP's strategic plan.

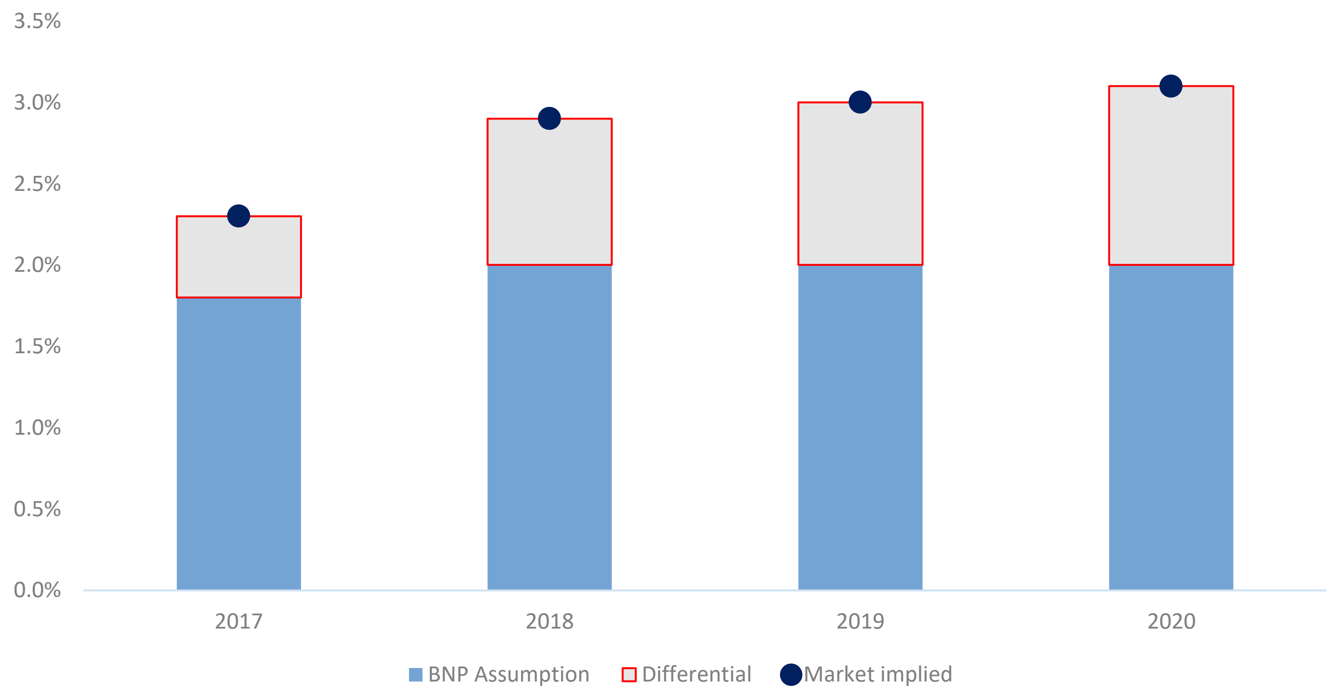
Consider, for example, *Figures 12 and 13*, which illustrate the differential between interest rates assumed in BNP's plan, and those currently implied in the market. BNP has been similarly conservative in its estimates of GDP growth (*Figure 14*). We estimate that the 2020 ROE, based on current market-implied rates and less conservative GDP assumptions, would be closer to 12%. If EU rates move meaningfully higher, say a 1%-2% upward shift in the yield curve (i.e. closing the gap in rates shown in *Figure 7* above), this could see BNP's ROE approaching 14%. It would, however, probably take 3 years or more for higher rates to show their full effect on the income statement. This is because BNP's interest-rate sensitivity has a "lag" effect: for a given change in interest rates, the major effect is felt only 2-3 years thereafter. This lower level of interest-rate optionality is evidently part of the reason why EU banks trade at a structural P/B discount to US banks.

Figure 12: 'BNP 2020 Plan' assumptions on French interest rates



Source: BNP Paribas

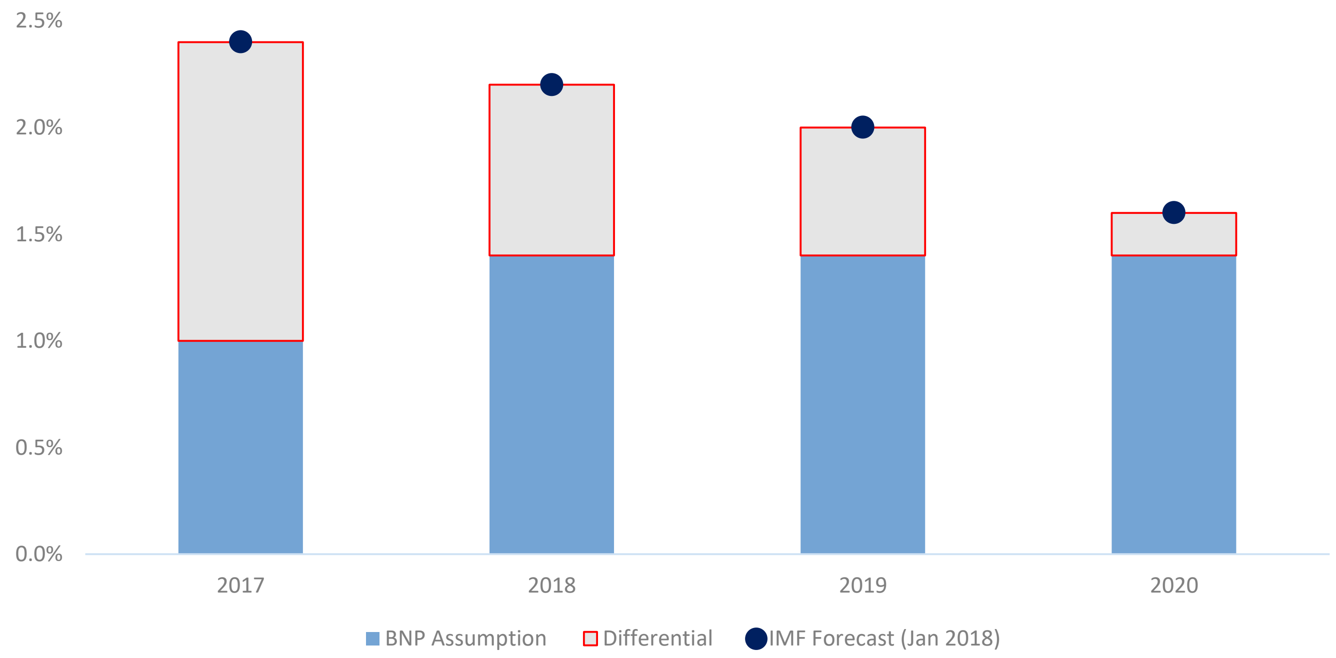
Figure 13: BNP's assumptions on US interest rates



Source: BNP Paribas

How does this translate into a fair-value estimate? On the basis of this normalised ROE estimate, and an estimate of the cost of capital, we can estimate a 'fair P/B' multiple for BNP. For the sake of prudence, we think it is reasonable to work with an ROE range of 10%-12%, and a cost of equity range of 9%-10%. This generates a fair P/B range of 1-1.6x (*Figure 15*). Relative to the current P/B multiple of 0.78x this suggests, at least theoretically, very meaningful upside (1.25x P/B is 60% higher than spot). We would prefer to be conservative, and pencil in a 0.95x P/B multiple; this still suggests 20%+ (euro) potential return on the stock. This is attractive relative to our 7% (US dollar) expected return on global equities in 2018.

Figure 14: 'BNP 2020 Plan' assumptions on EZ GDP



Source: Bloomberg

Figure 15: Price/Book estimates for BNP

PRICE / BOOK		ROE						
		7%	8%	9%	10%	11%	12%	13%
COST OF EQUITY	8%	0.8	1.0	1.3	1.7	2.2	3.0	4.3
	9%	0.6	0.8	1.0	1.3	1.6	2.0	2.6
	10%	0.5	0.7	0.8	1.0	1.2	1.5	1.9
	11%	0.5	0.6	0.7	0.8	1.0	1.2	1.4
	12%	0.4	0.5	0.6	0.7	0.8	1.0	1.2

Source: Anchor estimates

IN SUMMARY: This investigation has considered the value proposition offered by French banks and BNP Paribas in particular. Although French banks trade at structurally lower valuation multiples than their US peers, the gap appears to be wider now than what is currently justified. Under still quite modest assumptions, French banks like BNP could justify P/B multiples closer to 1x. This suggests potential returns of 20%+. The likely catalyst for such a rerating is a continued normalisation of monetary policy; particularly the possibility of an ECB rate hike in mid-2019, and the end of ECB QE during the current year.

Notes:

1. Source: Oxford Economics, UK.