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Outlook 2014 – A New Credit Cycle?

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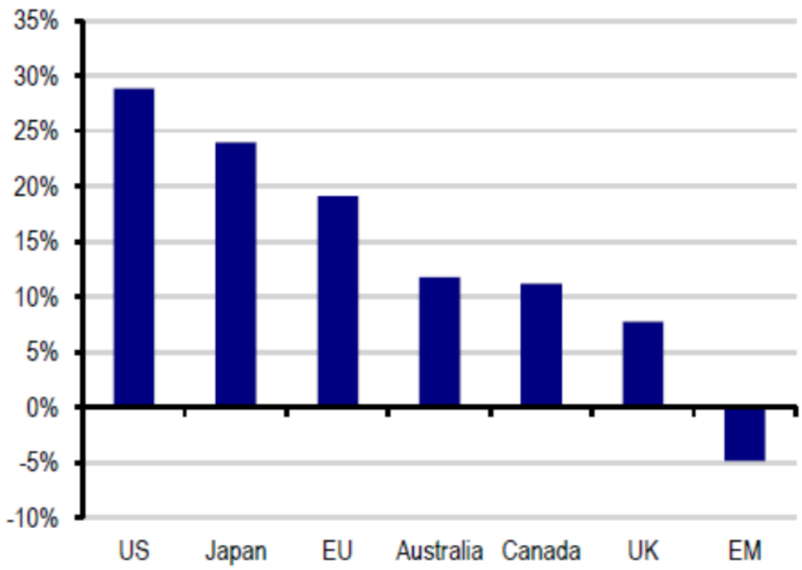
Despite ongoing uncertainties regarding Quantitative Easing ('QE'), the global banking sector looks set to post another strong year of performance. In 2013, the global banking sector was up 12.6% in US dollar terms and 18.0% in local currency. Although the sector performance compares less favourably to 2012 when the sector was up 21.8%, the outlook for 2014 is potentially poised to be well above the average annual performance of 3.6% since the year 2000.

By region, banks in the US (up 28.9%) and Japan (up 24.0%) registered the strongest performance in 2013 followed by European banks (up 19.1%). By contrast, emerging market banks registered a relatively weak performance compared to recent times (down 4.8% versus an average annual performance of 12.3% since 2000).

2013 Banking sector performance in US dollars



Source: Thomson Reuters, UBS.

The banking sector is essentially a leveraged play on an improving global economy where average annual GDP growth is estimated to accelerate from 2.5% in 2013 to 3.4% in 2014. Much of this improvement will likely be driven by the US economy accelerating to a growth rate of over 3.0% and Europe has also returned to growth after several years of recession. Barring the base effect-driven bounce-back in 2009/10, this would be the strongest year for global growth since before the financial crisis.

Other reasons to be more positive about the growth outlook for 2014 include:

- **A new credit cycle?** After five years of credit de-leveraging, the UK and US banks could be on the verge of a new lending cycle bolstered by a recovering housing market, policy support and/or potential for consumers to commence re-leveraging. Loan growth expectations are somewhat low, but could easily improve with further signs of economic recovery, increasing business confidence and lending standards potentially being further relaxed.

- **Balance-sheet strength**: Five years after the demise of Lehman Brothers, the aggregate balance sheet of the global banking sector has improved considerably in terms of capital, funding and asset quality and is likely to continue to improve due to the following reasons:
  - The requirements for higher regulatory capital, that is, the level of tangible capital to risk-weighted assets ('RWA'), has increased from 7.9% at the end of 2008 to 12.5% forecast at the end of 2013. This is despite the definition of RWA being far more onerous today.
  - Reflecting the lower sector dependency on wholesale funding by the banking sector, the Loan-to-Deposit ratio ('LDR') has reduced from an average of 100.8% in 2008 to an estimated 89.6% by the end of 2013. This ratio may well increase this year in-line with a pick up in credit demand.
  - The Non-Performing Loan ('NPL') ratio has declined from 3.3% in 2008 to an estimated level of 2.7% by the end of 2013, while the NPL coverage ratio increased from 102% in 2008 to an estimated 120% at the end of 2013.

- **Earnings growth**: Despite ongoing regulatory uncertainties and a slowdown in emerging markets, we anticipate a positive earnings growth outlook for the sector. Reflecting a gradual recovery in loan growth, improving top-line revenue growth and increased cost control, the outlook for sector earnings is very positive driven largely by banks in developed markets.

- **Valuation support**: In spite of the recovery in sector performance over the past year, valuations of global banks are still quite compelling. On a 2014 basis, global banks trade on approximately 9.9x Price to Earnings ratio (P/E) and 1.0x Price to Book Value (P/BV) versus a sector Return on Equity (ROE) of 11.8%. The dividend yield is also anticipated to increase to around 3.4% this year and the P/BV relative (to global equity valuations) also looks attractive, with the global banking sector trading at a 37% discount versus the historical discount average being 24%.

Global Banks: Price to book valuation relative to global equities

Source: I/B/E/S, Thomas Reuters, UBS.

Key Themes for 2014

In our view, the following key themes will likely impact global banks and global equities in 2014, both in terms of industry underlying fundamentals as well as broader sector performance.

- **Credit cycles**: Cyclicality will no doubt be crucial for gauging credit demand in 2014. From a top-down perspective, financials in the UK and US appear to be well placed and this could lead to loan growth and earnings momentum. In contrast, financials in emerging markets appear to be more at a later stage of the credit cycle and will likely be faced with slower growth and possibly a higher provisioning burden.

- **QE tapering and rates**: Tapering has finally commenced, albeit at a minimal level so far. As we experienced in 2013, concerns regarding tapering and the pace of tapering impacted risk appetite, resulting in currency and increased market volatility.

- **Ongoing regulatory concerns**: Global regulation of the financial sector continues to remain an ongoing theme and is costly. Regulatory issues this year are particularly focused on leverage ratios and credit risk weightings. Given the sector is still only part way through the implementation of Basel III, this will be an ongoing theme and may result in some unintended consequences. Other regulatory concerns for the year ahead include the full implementation of the Volcker Rule that seeks to prevent banks using approved deposit funds for more speculative types of investments; and, the potential risk of further litigation arising from ongoing investigations into Libor price manipulation and other foreign exchange price manipulation by certain banks.

We believe that on a valuation basis and given the prevailing macroeconomic environment, the global banking sector is set to perform strongly in 2014. As always, the strength of that performance will to a great extent be driven by the way that global banks manage the sector's risk profile, particularly the regulatory agenda.

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