Credit Demand, Stable Funding Costs Boost Banking Industry

The global banking industry continues to see earnings expansion as credit demand remains healthy in the developed world while funding costs are stable. The risk of negative returns on balances maintained with central banks has disappeared as quantitative easing programs in Europe and Japan are likely to be unwound over the next few years. In the U.S., delays in the expected easing of regulatory controls have not yet disappointed investors as bank margins in conventional lending have expanded. In emerging countries, provisions for loan losses have come down steadily over the last year as improved economic conditions and higher commodity prices have helped revive cash flows in most sectors.

KEY TAKEAWAYS

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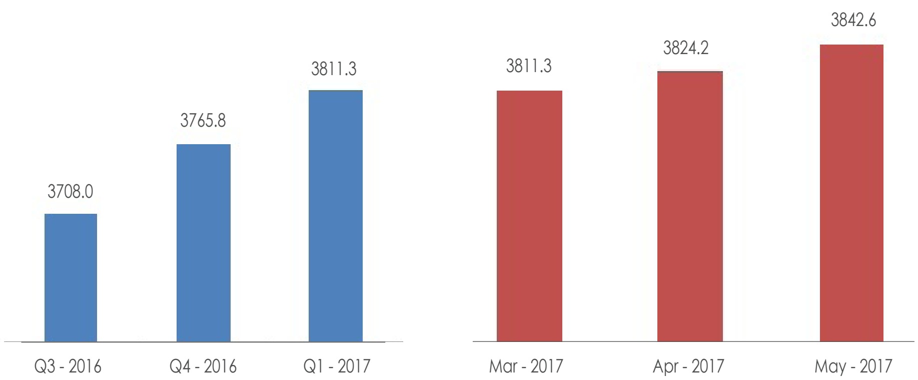
Healthy credit demand, growing fee income, and tight control over costs have supported earnings growth at the large U.S. banks in recent quarters. This trend is likely to continue as the interest rate hikes by the Federal Reserve should help protect net interest margins, and allow further expansions if demand for loans remains strong.

Consumer credit growth in the U.S.



Total consumer credit outstanding (seasonally adjusted), in billions of USD

Data source: U.S. Federal Reserve

Income from advisory and intermediation continues to grow, from both business and retail customers. These gains have more than offset the persistent weakness in areas like fixed income trading that were prominent profit centers in earlier years. The steady expansion in revenue and earnings has also held back investor disappointment over the delayed regulatory overhaul. The much anticipated easing of regulatory restrictions in the banking industry is considered unlikely before the end of this year. The most recent review by the Federal Reserve showed that almost all of the largest U.S. lenders have sufficient capital buffers to survive a crisis. Accordingly, the large banks have been allowed to step up buy backs and increase dividend payouts.

The better than expected economic trends in Europe and Japan should help the banking industry in those regions as well. Compared to their American peers, the European banks were slow in rebuilding their balance sheets after the crisis. The banking industry in select European countries, such as Italy, still suffers from low capital buffers and weak asset quality. Nevertheless, the overall health of the banking industry in Europe has improved over the last year. Even some of the British and German banks that have struggled to improve earnings for several years now appear to be recovering. Despite the challenges in Italy, the European banking union also appears to be gaining strength. The union should get a further lift if Sweden and Denmark join as expected.

Banks in large emerging countries are likely to gain from the sustained expansion in consumer credit demand, as well as a recovery in business loans. As these economies are now in better shape, compared to recent years, growth in loan losses have come down.

More banks are likely to scale down their London operations over the next two years as the U.K. exits the European Union. Parts of the operations that involve EU regulations are expected to be relocated to other European cities such as Frankfurt and Paris. This process is likely to bring down income levels in London and the Bank of England is expected to hold its benchmark rates unchanged during the transition period.

Banks in large emerging countries are likely to gain from the sustained expansion in consumer credit demand, as well as a recovery in business loans. As these economies are now in better shape, compared to recent years, growth in loan losses have come down. In select countries in South East Asia, credit costs have declined from last year. Inflation risks are well contained, and should allow central banks to maintain current benchmark interest rates in most countries. If the economic recovery is sustained, funding demand for longer-term projects could increase as businesses step up capital spending. In Latin America, Brazilian banks should benefit from further rate cuts by the central bank. Banks in emerging countries are also better capitalized when compared to previous downturns, with better credit risk monitoring systems in place.

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> *— Thomas S. White, Jr., Portfolio Manager*

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