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In Europe, It’s Time to Bet on the Banks

After a quarter of strong earnings, the financial sector hasn’t moved ahead of the broader market. Many financial stocks still have appealing valuations.

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Europe’s financial firms are coming off a terrific second quarter in earnings, with average gains of 35% from a year earlier. In fact, the once-beleaguered financials are “leading the recovery in earnings growth” in Europe, says a recent Barclay’s research note. So, how come their stocks aren’t roaring ahead of the pack?

These firms, in particular the large banks, have benefited from stronger stashes of capital, a modestly improving economic picture in Europe, and signs that loan growth is finally returning. What’s more, the crisis in Greece appears to be contained, if not solved.

But the stocks of the financial-services sector have yet to distinguish themselves. In local currency the MSCI Europe Financial Index has appreciated 18% in the past 12 months, about even with the Euro Stoxx Index. The good news is that many of these companies still sport very reasonable valuations. **On average the stocks trade at just around book value; before the financial crisis of 2008, banks traded at closer to two times book.**

“Those banks that were looking cheap are looking even cheaper, and those banks that were looking risky are looking less risky,” says Anis Lahlou-Abid, co-portfolio manager of the JPMorgan Intrepid European fund (ticker: VEUAX). The fund is overweight financials. As of June 30, its holdings included Lloyds Banking Group (LLOY.UK) and UBS Group(UBS).

There’s no question that most of the banks are on much stronger footing than in recent years. For the large banks, their combined common equity Tier 1 capital ratio is close to 12%, up from 9.4% in 2012, according to Exane BNP Paribas. But the entire sector isn’t out of the woods just yet. Lahlou-Abid says the fund he helps run is underweight Spain, partly because of concerns about weak loan growth there.

Beyond that, the European economy, while far from robust, is improving, providing a sounder foundation for these companies. Unemployment remains high, at 11%. But it has been declining since June 2013, according to JPMorgan Asset Management. And for the banks, the all-important supply and demand of credit is improving.

“We are in a better place in Europe,” says Laurent Frings, co-head of credit research for Europe, the Middle East, and Africa at Aberdeen Asset Management in London. “We’ve seen a number of signs of activity picking up, though it’s still not even across the continent. The United Kingdom is clearly doing better than many countries out there.”

One bank drawing fresh attention is Lloyds, which trades at around 80 pence ($1.25)—and at a reasonable 1.2 times tangible book value. “They are generating good organic Tier 1 capital,” along with respectable loan growth, says Richard Nield, a co-manager of theInvesco European Growth fund (AEDAZ). He thinks the shares could hit 100 pence, or 25% above the recent price, within 12 months. Hit hard by the financial crisis, Lloyds needed a bailout from the British government to survive; the government’s stake is now below 20%.
Similarly, Frings of Aberdeen likes Lloyds’ corporate bonds. The bank has relied heavily on selling assets, restructuring, and letting existing loans run off, or reach their maturity, he says. That has led to a smaller balance sheet requiring less funding, and improved capital ratios.

One caveat: Many U.S. investors haven’t fully benefited from the upswing in European financials because of the strong dollar. The stocks’ gains are reduced when translated into dollars, and that problem could persist. “My impression is that most Europe-focused funds in the U.S. do not hedge their currency exposure, or may just do small portions,” says Gregg Wolper, a senior analyst at Morningstar. Whether you’re investing through funds or buying individual stocks, it pays to seriously consider this issue.

NEWS OF CHINA’S DEVALUATION hit European stock markets hard last week. On Aug. 12 alone, the Euro Stoxx Index was down 3.1% amid concerns that exports from the Continent will become more expensive in China, crimping demand. The European markets regained some ground on Aug. 13, only to sell off a bit the next day after reports of slightly weaker-than-expected second-quarter euro-zone growth. For the week, the market closed down 2.73%.

In a note to clients earlier this month, Srinivas Thiruvadanthai, director of research at the Jerome Levy Forecasting Center, warned of such a problem. “The euro area’s economic expansion lacks a domestic engine and is seriously vulnerable to adverse developments in the rest of the world, especially in emerging-market nations,” he wrote.

Nield of Invesco, however, isn’t too worried. “Based on what we think the earnings impact will be, it’s a bit overdone,” he says. He points out that exports to China account for only about 4.5% for Germany’s gross domestic product.

Just how much the yuan’s devaluation will hurt the economies of Europe is difficult to assess, but it clearly bears watching for stock investors.

Europe

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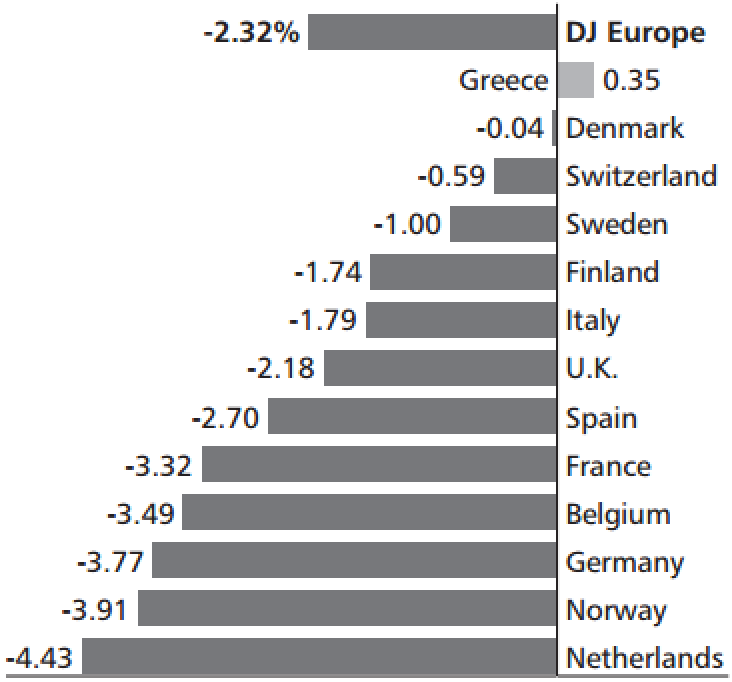

Indexes based on DJ Total Stk Mkt Source: S&P DJ Indices

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