GLOBAL Insight WEEKLY

Perspectives from the Global Portfolio Advisory Committee

July 20, 2023

Are low bank valuations a reason to buy the sector?

Frédérique Carrier – London

Historically, banks have tended to benefit from rising interest rates. In the U.S., Canada, UK, and Europe, bank valuations are compelling. Does that mean it is time to add bank exposure to global portfolios?

An unusual year

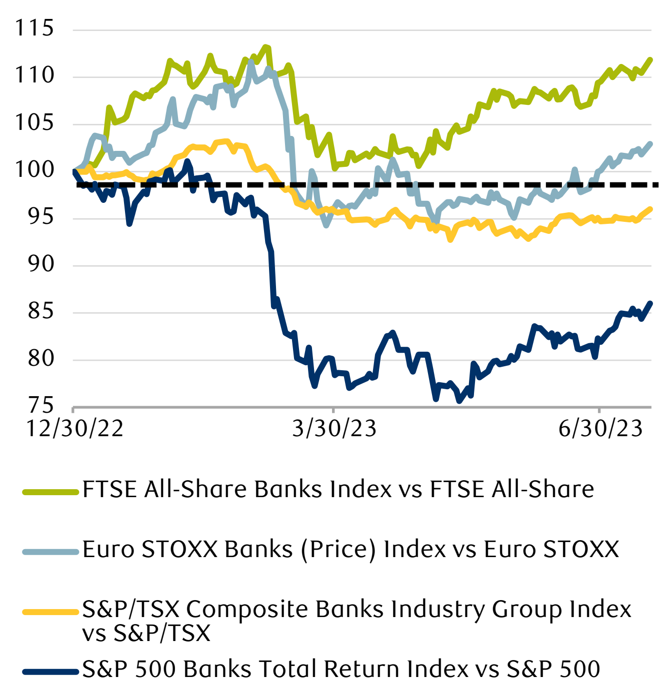
Banks have historically performed well when interest rates rise. When they do rise, banks are quick to pass on interest rate increases to borrowers, but slow to pass them on to depositors. Thus, their net interest margins tend to increase.

In fact, in late June, UK Chancellor of the Exchequer Jeremy Hunt met with bank bosses to discuss how reluctant the banks had been to pass on higher returns to savers. Britain's four largest banks were then offering rates of less than 1.35 percent on easy access accounts, where close to two-thirds of household deposits are held, at a time the Bank of England (BoE) had raised the bank rate to 4.5 percent, according to the Treasury Select Committee.

With the delay between raising borrowing costs and deposit rates, banks' profitability can improve, as long as the lending cycle remains benign and loan loss provisions restrained. This can lead to bank stocks outperforming.

However, it has not been the case this year, of course, due to the failure of three U.S. regional banks, and the collapse of Credit Suisse in Europe which all rattled the sector. U.S. bank stocks have underperformed the broader market year to date. European banks have barely outperformed, while UK banks, widely perceived as having

Performance of local bank indexes relative to their broad domestic markets



Source - RBC Wealth Management, Bloomberg; data through 7/17/23

For perspectives on the week from our regional analysts, please see pages 3–4.

For important disclosures, required non-U.S. analyst disclosures, and authors' contact information, see page 6.

Priced (in USD) as of 7/19/23 market close (unless otherwise stated). Produced: 7/20/23 2:27 pm ET; Disseminated: 7/20/23 2:40 pm ET

avoided these issues, have held up better, largely thanks to international banks performing well as banks catering solely to the domestic market struggled.

U.S. status update

The ongoing U.S. earnings season is providing a useful temperature check for the sector. Gerard Cassidy, RBC Capital Markets, LLC's head of U.S. bank equity strategy, expects a subdued earnings season overall. He cautions that due to the regional bank crisis, the traditional expansion in net interest margin at this point in the cycle may not have materialized as banks had to pass on interest rate increases to depositors more swiftly than usual to avoid deposit flight. While the largest banks have mostly avoided this squeeze, the jury is still out on the smaller and regional competitors.

Cassidy expects credit quality to remain strong for now, with the exception of the commercial real estate sector. But with credit losses still at unsustainably low levels, he anticipates loan loss provisions to start to increase from Q2 2023 compared to prior periods as banks start to build up their loan loss reserves. Most banks still factor in a mild recession in their outlooks.

As for the strength of the banking sector's capital base, the results of the Dodd-Frank Act Stress Test show that the capital positions of the largest U.S. banks would remain strong even in a severely stressed scenario. This enables most of the large banks to afford compelling dividend payouts.

Lori Calvasina, RBC Capital Markets, LLC's head of U.S. equity strategy, recently upgraded Financials to Overweight from Market Weight. Valuations are not demanding, in her view, with the top 20 bank stocks trading at 1.0x book value, on average, and 8.2x 2023 estimated EPS. She also thinks the sector can serve a cyclical function in portfolios as it tends to outperform when ISM manufacturing data is rising. If confidence in a 2024 economic recovery gathers steam, she believes that banks could benefit.

The risk of adding banks to portfolios now is that if a recession materializes, as the reliable leading indicators we follow suggest, the sector would struggle to outperform the broader market. The recent pro-cyclical stock market run suggests a benign economic environment is being discounted, leaving banks vulnerable, in our view, if a darker economic scenario prevails.

Meanwhile, north of the border

Canadian banks' valuations, at 1.3x book value, are nearing the stressed levels reached during the global financial crisis of 2008. This reflects slowing loan growth, higher deposit costs and loan losses, while the regulatory environment is increasingly unfriendly. A potential peak in loan losses, as well as opportunities linked to immigration could unlock the sector's low valuations, though we think the state of the economy remains the key short-term concern.

Nuances across the pond

In the UK, the BoE also performed a stress test recently to assess the resilience of the sector's capital position. The results indicated that the major UK banks would be resilient to an economic scenario more severe than the 2007–08 global financial crisis, an outcome substantially worse than that currently expected by the BoE and consensus.

Therefore, we do not foresee changes to forthcoming share buybacks or dividends for the group. UK bank valuations are not demanding with the sector trading at 6x this year's earnings and 0.7x price to book value. Nevertheless, we believe renewed positive economic momentum is likely needed for UK bank shares to re-rate materially higher.

Unlike their U.S. counterparts, European banks have continued to enjoy earnings upgrades throughout this year, reflecting the benefit of higher interest rates on their net interest margin. European bank valuations are similar to those in the UK, but we would remain selective and focus on banks of the highest quality given the current subdued economic environment.

Timing is key

We expect the ongoing Q2 corporate earnings season to give clues as to how the banking sector is navigating the current tricky economic environment. The sector in the U.S., Canada, UK, and Europe is well capitalized, and valuations are undemanding. In the short term, however, given the recent rally in the sector, which was particularly strong in the U.S. and Europe, we believe bank stocks would be vulnerable should a deep economic slowdown materialize and loan losses increase sharply.

With contributions from Thomas McGarrity, CFA and Sunny Singh, CFA.

UNITED STATES

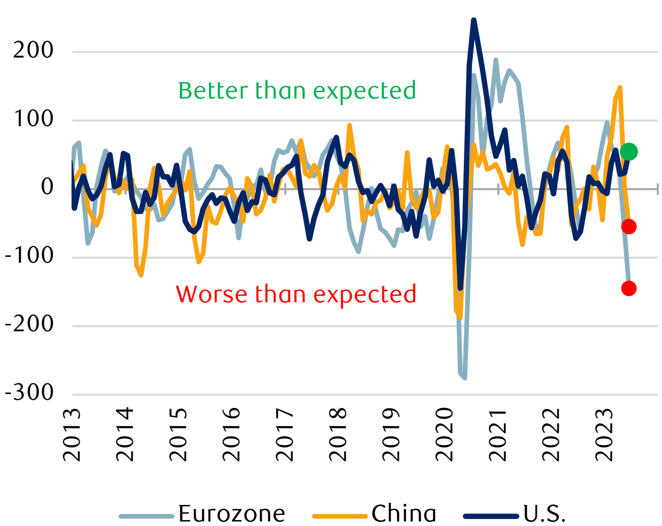
Tyler Frawley, CFA – Minneapolis

- **U.S. equities are moving higher this week as earnings season gets underway.** All major indexes are higher on the week, with the Dow Jones Industrial Average being the top performer, up 2.35%. The S&P 500 has slightly outperformed the Nasdaq Composite, but both are up—0.96% and 0.22%, respectively. Financials has been the best-performing sector this week, up 3.06%, as banks' earnings results have been coming in better than the consensus feared.

- **U.S. economic data remains resilient, but weakness abroad is emerging.** According to the Citigroup Economic Surprise Index, which provides a snapshot of how an economy is faring relative to consensus economic forecasts, U.S. data has continued to come in stronger than expected as inflation moves lower, employment remains resilient, and the housing industry shows signs of recovery. However, looking at the same index for the eurozone and China gives a different picture. The readings for both regions have fallen into negative territory in recent months, indicating economic data is undershooting expectations. In the eurozone, weakness in manufacturing and falling retail sales have weighed on economic results. In China, retail sales have fallen and Q2 GDP came in below consensus expectations. While ongoing resilience from the U.S. economy is a welcome development, economic slowdowns in other parts of the world are worth watching considering the interconnected nature of the global economy.

U.S. economic data remains resilient as weakness emerges abroad

Citigroup Economic Surprise Indexes for major economies



A reading above zero indicates economic data has been better than expected; a reading below zero indicates economic data has been worse than expected.

Source - RBC Wealth Management, Bloomberg; data through June 2023

- **Initial unemployment claims fell to their lowest levels in two months.** The Department of Labor released data on the morning of July 20 that showed initial unemployment claims dropping to 228,000 for the week ending July 15, well below the consensus expectation of 241,000, and down from 237,000 last week. The report is the latest indicator of just how tight the labor market has remained as companies hoard workers after struggling to find labor during the COVID-19 pandemic, despite the aggressive rate hiking cycle by the Federal Reserve.

CANADA

Matt Altro & Richard Tan, CFA – Toronto

- **Canadian headline inflation slowed to 2.8% y/y in June**, slightly below the consensus expectation of 3.0%. The softer-than-expected data was primarily **driven by the pullback in energy prices**. Benchmark West Texas Intermediate crude oil and gasoline prices retraced by approximately 32% and 22%, respectively, from a year prior. On the flip side, food and mortgage interest costs continue to be key drivers of inflationary pressure, with the latter climbing by 30% y/y. In the bigger picture, **inflationary pressure remains broad in nature and consumer spending has proven to be relatively resilient**. As a consequence, we believe interest rates will likely remain high for the duration of the year, with the potential for one more rate hike by the Bank of Canada (BoC) before the end of 2023. RBC Economics is forecasting potential rate cuts by the BoC in the second half of 2024, but we believe rate cuts could be more gradual should they materialize next year.

- **After a couple of months of strength, Canadian housing market activity began to decelerate from the levels seen in April and May.** Supply improved modestly, with new listings growing faster than sales for the second month in a row (+5.95% m/m in June). Unfortunately, the housing supply shortage in Canada remains acute amid robust and growing demand. In June, national home prices rose by 2.0% m/m, with the largest increases in British Columbia and Ontario, and more muted gains in Saskatchewan, Manitoba, and Quebec. RBC Economics believes the strength in the housing market over the past few months was not sustainable, and expects the trajectory in resales to be flatter as affordability conditions and a slowing economy increasingly work against buyers.

EUROPE

Thomas McGarrity, CFA & Blaine Karbonik, CFA – London

- **Long-awaited signs of disinflation have finally appeared in the UK.** The latest UK inflation data surprised to the downside in June, marking the first time in five months that the pace of price growth came in below consensus expectations. Headline inflation slowed to 7.9% y/y in June, a significant decline from the 8.7% y/y reading in May and the lowest level in 15 months.

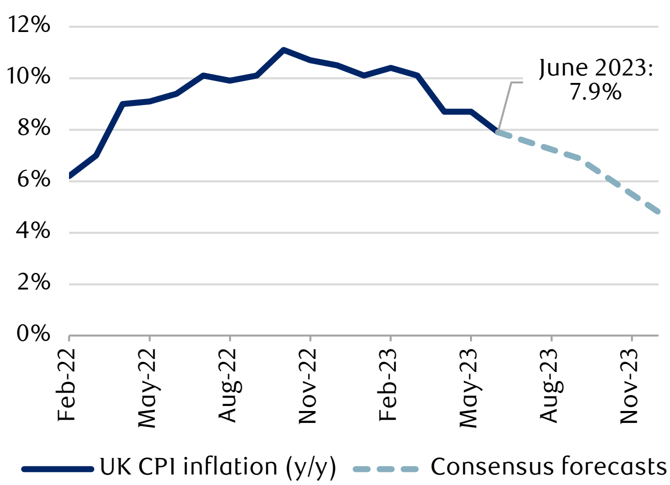
- **Bonds rallied following the announcement, and markets pared back expectations for interest rate hikes from the Bank of England (BoE).** Market pricing projects the policy rate to peak at 5.75%, a sizable shift lower from the 6.50% peak markets were pricing just 10 days earlier. The BoE's Monetary Policy Committee (MPC) is next set to meet in August, and markets are now evenly split on whether a 25 basis point (bps) or 50 bps hike will prevail. RBC Capital Markets maintains its call for a 25 bps rate increase at the August MPC meeting, and it believes the BoE will under-deliver relative to market expectations with a terminal rate of 5.5%.

- **The inflation surprise put a halt to the British pound's recent rally; sterling fell over 1% against the U.S. dollar and the euro following the announcement.** Persistently high inflation and increasingly hawkish expectations for BoE rate hikes have been key drivers of sterling's recent strength. As markets recalibrate tightening expectations, further sterling weakness cannot be ruled out, in our view.

- **The softer-than-expected inflation reading also boosted UK equities**, with the FTSE All-Share gaining almost 3% in the two trading days after the CPI report. The bounce was led by rate-sensitive domestic stocks such as housebuilders and commercial real estate, buoyed by falling projections for BoE interest rate rises. While the unexpected cooling of UK inflation may have provided a little bit of relief for domestic stocks, we continue to have a strong bias for internationally orientated companies within UK equities.

A welcome relief

UK CPI inflation surprised to the downside in June



Source - RBC Wealth Management, Bloomberg

ASIA PACIFIC

Emily Li – Hong Kong

- **On July 19, Chinese authorities issued guidance on boosting the growth of the private economy** that included promises to improve the business environment, enhance policy support, and strengthen the legal underpinnings of business development. Chinese officials have recently taken a series of high-profile actions to demonstrate their support for private firms in an effort to prevent the nation's post-pandemic recovery from being hindered by a lack of market confidence. In recent weeks, the Chinese leadership has made a commitment to improving the treatment of foreign investors and has called for greater openness. As part of this effort, top officials have extended a warm welcome to foreign executives including Elon Musk.

- **China's economic recovery showed signs of losing momentum in Q2, placing Beijing's growth target for the year in jeopardy and raising concerns about a potential slowdown in the global economy.** Despite growing at a slightly slower-than-anticipated rate of 6.3% y/y, the country's GDP was down by less than 1% from Q1. The latest data revealed that deflation is now a major risk, with prices declining across the board for the first time since 2020, while youth unemployment has surged to over 21%. These developments have reinforced calls for further economic stimulus, with attention now turning to a meeting later this month of the Communist Party's Politburo that will determine economic policies for the remainder of the year. The People's Bank of China has hinted at the possibility of increased policy support, including more targeted support for the property market.

- **The Biden administration's proposed restrictions on investments in China will focus specifically on cutting-edge technology and will only apply to new investments.** The program, which has been delayed several times, is unlikely to be implemented until early 2024 due to the necessary bureaucratic processes in Washington. U.S. officials intend to finalize a proposal by the end of August aimed at scrutinizing, and possibly preventing, investment in China's semiconductor, quantum computing, and AI sectors.

MARKET
Scorecard

Data as of July 19, 2023

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,565.72	2.6%	18.9%	16.0%	7.2%
Dow Industrials (DJIA)	35,061.21	1.9%	5.8%	10.2%	3.2%
Nasdaq	14,358.02	4.1%	37.2%	22.6%	0.6%
Russell 2000	1,984.89	5.1%	12.7%	10.3%	-6.8%
S&P/TSX Comp	20,491.17	1.7%	5.7%	8.2%	3.9%
FTSE All-Share	4,151.54	1.3%	1.9%	3.3%	6.2%
STOXX Europe 600	461.97	0.0%	8.7%	9.1%	4.0%
EURO STOXX 50	4,362.28	-0.8%	15.0%	21.6%	11.0%
Hang Seng	18,952.31	0.2%	-4.2%	-8.3%	-31.1%
Shanghai Comp	3,198.84	-0.1%	3.5%	-2.5%	-9.6%
Nikkei 225	32,896.03	-0.9%	26.1%	22.0%	19.0%
India Sensex	67,097.44	3.7%	10.3%	22.5%	27.7%
Singapore Straits Times	3,275.24	2.2%	0.7%	5.1%	5.3%
Brazil Ibovespa	117,552.07	-0.5%	7.1%	19.7%	-5.5%
Mexican Bolsa IPC	53,727.11	0.4%	10.9%	13.7%	9.4%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	3.746%	-9.0	-12.9	72.5	255.8
Canada 10-Yr	3.356%	8.7	5.6	26.9	221.2
UK 10-Yr	4.215%	-17.3	54.3	203.5	365.5
Germany 10-Yr	2.438%	4.6	-13.3	116.1	282.4
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.75%	0.4%	2.5%	-0.8%	-11.8%
U.S. Investment-Grade Corp	5.42%	0.4%	3.6%	1.2%	-13.7%
U.S. High-Yield Corp	8.29%	1.2%	6.6%	7.4%	-3.6%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,977.36	3.0%	8.4%	15.5%	9.1%
Silver (spot $/oz)	25.15	10.4%	5.0%	34.0%	-0.1%
Copper ($/metric ton)	8,444.99	1.5%	1.0%	16.4%	-8.1%
Oil (WTI spot/bbl)	75.35	6.7%	-6.1%	-27.7%	13.4%
Oil (Brent spot/bbl)	79.48	6.1%	-7.5%	-26.0%	15.8%
Natural Gas ($/mmBtu)	2.62	-6.3%	-41.4%	-63.9%	-30.6%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	100.2900	-2.5%	-3.1%	-6.0%	8.0%
CAD/USD	0.7595	0.6%	2.9%	-2.3%	-3.2%
USD/CAD	1.3166	-0.6%	-2.9%	2.3%	3.3%
EUR/USD	1.1203	2.7%	4.7%	9.5%	-5.1%
GBP/USD	1.2939	1.9%	7.1%	7.9%	-5.4%
AUD/USD	0.6773	1.6%	-0.6%	-1.8%	-7.8%
USD/JPY	139.7100	-3.2%	6.6%	1.1%	27.6%
EUR/JPY	156.5100	-0.6%	11.5%	10.7%	21.2%
EUR/GBP	0.8658	0.8%	-2.2%	1.6%	0.3%
EUR/CHF	0.9618	-1.6%	-2.8%	-2.9%	-11.2%
USD/SGD	1.3249	-2.0%	-1.1%	-4.9%	-2.8%
USD/CNY	7.2232	-0.4%	4.7%	7.1%	11.3%
USD/MXN	16.7113	-2.4%	-14.3%	-18.6%	-16.8%
USD/BRL	4.7850	0.0%	-9.4%	-11.6%	-8.9%

Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD 2.9% return means the Canadian dollar rose 2.9% vs. the U.S. dollar year to date. USD/JPY 139.71 means 1 U.S. dollar will buy 139.71 yen. USD/JPY 6.6% return means the U.S. dollar rose 6.6% vs. the yen year to date.

Source - Bloomberg; data through 7/19/23

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As of June 30, 2023

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Sell [Underperform]	49	3.37	3	6.12

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