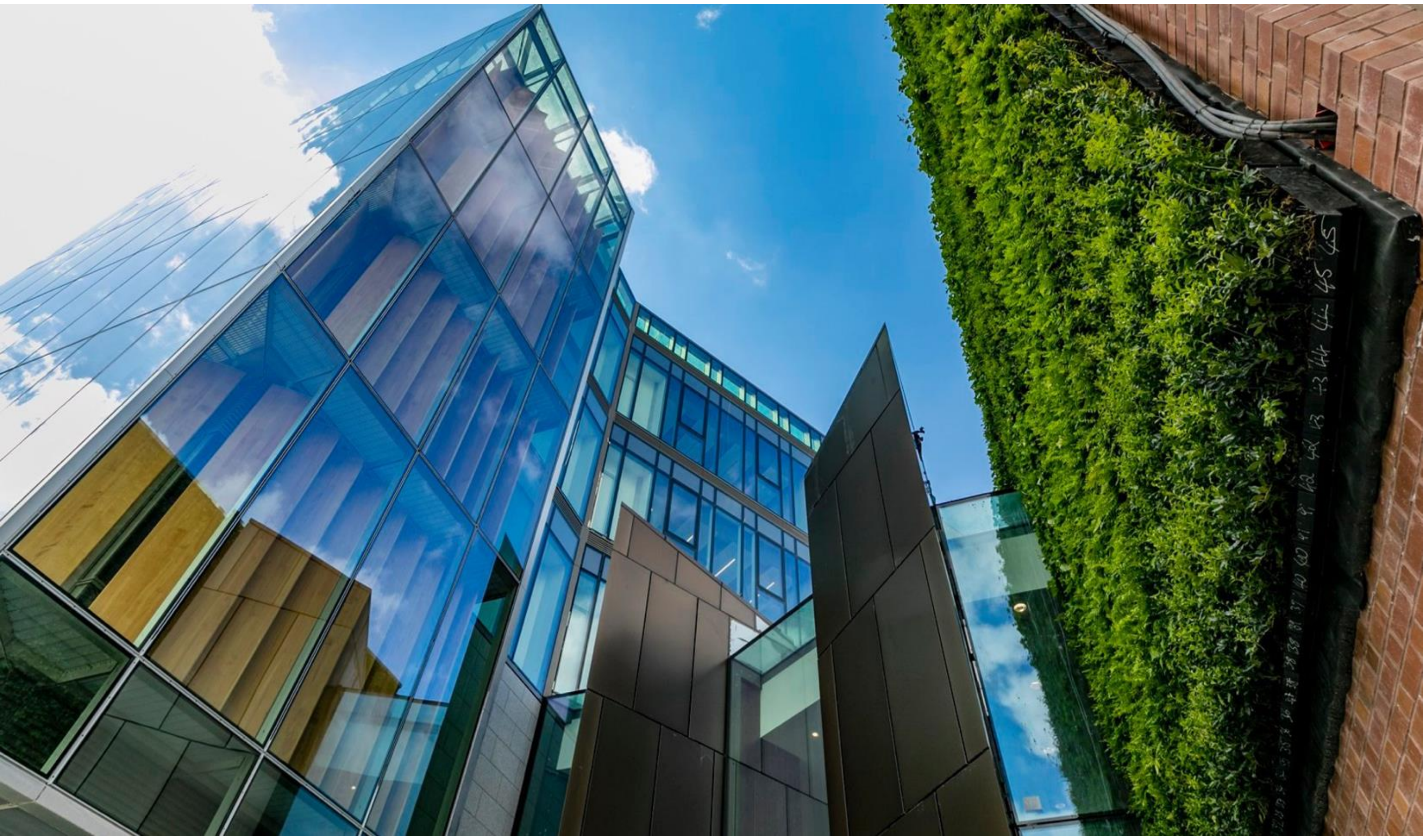
Trinity Student Managed Fund
Sector Reports

Financial Banks

September 2024



TRINITY SMF
STUDENT MANAGED FUND

Table of Contents

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Sector Overview

Banks are a Subsector of the Financial sector in the Global Industry Classification Standard (GICS®), which is made up of thirteen sectors. At its core, a bank is an institution within the financial sector that serves as a crucial bridge between those who have excess funds and those who require funds to meet their various financial needs. The primary idea behind a bank revolves around the concept of financial intermediation. In essence, banks facilitate the efficient allocation of resources in an economy by collecting funds from individuals, businesses, and institutions with surplus funds and channeling these funds towards borrowers who need capital for various purposes, such as investments, purchases, or operational expenses.

There are three main forms of banking, the first two fall under Commercial Banks, banks that primarily make their money by lending to customers and profiting from their interest margin. Investment banks, who advise clients on mergers and acquisitions (M&A), facilitate equity and debt offerings, manage wealth for high-net-worth clients and businesses, and more. Lastly, Universal banks which combine the two.

Retail Banking

Retail banks are the most common type of bank and the type of bank that most people are familiar with, also known as consumer banking or personal banking. Retail banks offer a wide range of services such as checking and savings accounts, mortgages, personal loans, credit cards, and certificates of deposit (CDs). The purpose of retail banking is to provide individual consumers with a way to manage their money, have access to credit, and securely deposit their funds. Examples of retail banks include HSBC, Wells Fargo, and BNP Paribas.

Corporate Banking

Corporate banking, also known as institutional banking, is a division in a bank responsible for putting together loans to corporations, financial institutions, and governments. The purpose of corporate banking is to provide businesses with the necessary funding to grow and expand. Some examples of corporate banks include Bank of Ireland, Citibank, and JPMorgan Chase.

Mergers and Acquisitions

Investment banks provide advice and assistance to companies involved in mergers, acquisitions, and other corporate restructurings. This includes valuing potential targets, evaluating the potential synergies of a M&A, and providing advice on the structure and financing of the deal. Examples of M&A deals include Facebook's (now Meta) acquisition of Whatsapp, or more recently, in the banking sector UBS's takeover of Credit Suisse.

Investment Banking

Investment banking is a type of banking that organises large complex financial transactions such as M&A or initial public offering (IPO)as well as underwriting, shareholder activism defense, restructuring Investment banks may raise money for companies in a variety of ways, including underwriting the issuance of new securities for a corporation, municipality, or other institution. They may also manage a corporation's IPO and provide advice in M&A, and reorganisations. Some examples of investment banks include Goldman Sachs, Morgan Stanley, and JPMorgan Chase.

Sales and Trading

Investment banks act as intermediaries between buyers and sellers of securities. They make markets in stocks, bonds, and other financial instruments, providing liquidity to the market by facilitating the buying and selling of these assets. Investment banks are on what is called the 'Sell-side,' where salespeople work with asset managers, hedge funds, insurance companies, and other buy-side investors to pitch ideas and to buy or sell securities or derivatives (financial contracts, i.e., warrants, options, futures etc)

Asset Management

Investment banks often have asset management divisions that manage money for high-net-worth individuals, pension funds, and other institutional investors. Asset managers invest in a range of securities, including stocks, bonds, real estate, commodities, and alternative investments

Wealth Management

Investment banks may also offer wealth management services to high-net-worth individuals. Wealth managers provide a range of financial services, including investment advice, estate planning, accounting, retirement planning, and tax services

Research

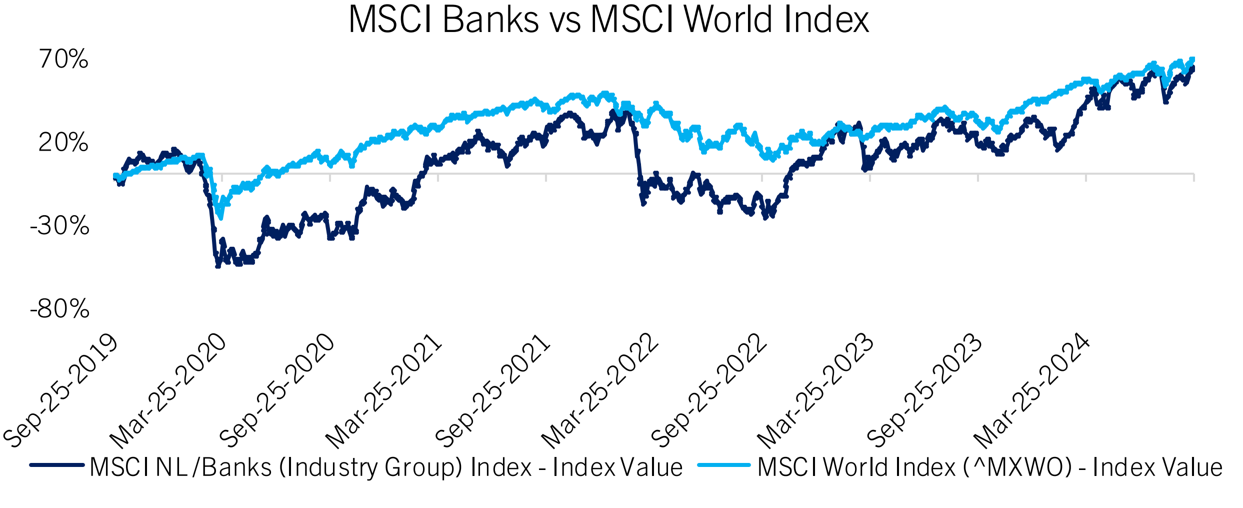
Investment banks employ analysts who research companies, industries, and markets to provide insights and recommendations to the bank's clients. Research analysts produce reports on individual companies or sectors that can be used by the bank's salespeople to pitch ideas to clients

Top 10 Constituents	Country	Mkt Cap (USD Billions)	Index Wt. (%)
JPMORGAN CHASE & CO	US	645.65	16.14
BANK OF AMERICA CORP	US	289.39	7.23
WELLS FARGO & CO	US	207.01	5.17
ROYAL BANK OF CANADA	CA	170.38	4.26
HSBC HOLDINGS (GB)	GB	165.44	4.13
COMMONWEALTH BANK OF AUSTRALIA	AU	158.43	3.96
CITIGROUP	US	119.97	3
MITSUBISHI UFJ FIN GRP	JP	116.53	2.91
TORONTO-DOMINION BANK	CA	105.94	2.65
SUMITOMO MITSUI FINL GRP	JP	82.09	2.05
Total	2060.82	51.5	51.5

MSCI World Bank index

The MSCI World Banks Index illustrates that the banking sector has provided mostly consistent growth since 2009, with the US accounting for a majority of the sector. It includes 73 constituents, the top 3 being JPMorgan Chase & Co, Bank of America Corp, and Wells Fargo & Co. The sector has experienced 21.64% YTD growth in Gross Returns (as at 31/07) as banks are continuing to deliver high returns on equity.

Bank stocks are generally considered to be cyclical. This means that their businesses and stock prices tend to follow the business cycle. They generally perform very well during economic expansions but typically underperform during recessions as sales drop, however, Consumer banking (taking in deposits and lending money) is highly cyclical, and this is especially true for banks that specialize in riskier forms of lending such as credit cards. On the other hand, investment banking tends to do even better during turbulent times, so banks that have large investment banking operations tend to see profits hold up quite well (6).



Current Climate

As we move into the latter part of 2024, the global economy is characterized by moderating inflation, slowing labor markets, and significant shifts in monetary policy, particularly in the US and the European Union. In the United States, inflation has cooled to 2.5% year-over-year, its lowest rate since early 2021. Core inflation, however, remains elevated, especially in the services sector, which continues to drive price pressures due to labor-intensive costs. In the Eurozone, inflation has also eased, with the European Central Bank (ECB) forecasting inflation to reach 2.5% in 2024 and 2.2% by 2025. This disinflationary trend has prompted both the Federal Reserve and ECB to pivot from their aggressive tightening stances and initiate interest rate cuts.

The Federal Reserve's decision to cut rates by 50 basis points follows a softening US labor market, with higher unemployment and weak nonfarm payrolls data triggering concerns of a potential recession. The European Central Bank also cut rates, reflecting concerns over economic weakness, though wage growth and persistent service inflation remain key factors influencing future policy moves. Investors, however, remain cautious as these rate cuts, while aimed at stabilizing economies, signal potential risks of slower growth or recession (8).

Impact of the 50 Basis Point Rate Cut on Banks

The Federal Reserve's 50 basis point rate cut, a larger-than-expected move, comes amid rising unemployment and weaker nonfarm payrolls, triggering concerns of a recession and invoking the Sahm Rule as a signal of economic downturn. While the Fed's July meeting didn't project this outcome, mounting recession fears have shifted expectations.

For banks, the rate cut presents mixed implications. Lower interest rates are likely to stimulate loan demand as businesses and consumers capitalize on cheaper borrowing costs, offering an immediate boost to lending activity. However, as rates decrease, banks face shrinking net interest margins (NIM)—the spread between the interest earned on loans and paid on deposits—which is a key driver of profitability. In a prolonged low-rate environment, this margin compression can reduce banks' earnings, particularly for those heavily reliant on traditional lending models. Furthermore, recessionary risks increase the likelihood of rising loan defaults, as weaker economic conditions strain borrowers' ability to meet debt obligations. The initial market selloff after the rate cut reflects investors' concerns about potential headwinds for the banking sector as it navigates slower economic growth, margin pressure, and the possibility of higher credit losses.

EU vs US Performance

Overall, both U.S. banks and European banks have performed well.

The Stoxx600 bank index and the KBW bank index, which measure European and US banks' performance respectively, both experienced robust year-to-date increases north of 14%. The historical gap in performance between US and European banks seems to have been somewhat bridged, following European banks' outperformance last year and subsequent year-to-date performance this year. This is largely driven by rising net interest margins in Europe and regulatory variations, compared to declining net interest margins in the US as a result of higher funding costs and slower loan growth. Additionally, record share buybacks by European banks have further contributed to their outperformance, providing a significant boost to their stock performance compared to their US counterparts (1).

Investment Themes

Diversified Revenue Streams

As interest rates decrease, traditional banks might face pressure on their net interest margins. However, diversified banks offering investment banking, asset management, wealth management, and insurance services can offset this by capitalizing on increased deal-making and financial advisory services.

Example Investments: Look for banks with a strong presence in retail and investment banking, such as universal banks involved in M&A activities, advisory services, and other non-lending operations. Leverage the breadth of financial services these banks offer to mitigate the risks associated with declining interest rates, which can provide more stable revenue stream

Capital-Strong Banks With High-Quality Assets

In anticipation of lower interest rates, banks with robust capital adequacy ratios and significant cash reserves will be better positioned to seize opportunities, such as acquisitions of undervalued companies or expansion in new markets. A strong balance sheet also ensures resilience against economic volatility.

Example Investments: Prioritise banks with solid Tier 1 capital ratios, substantial liquidity, and a conservative risk profile, focusing on those with a proven track record of navigating interest rate fluctuations effectively. To safeguard the portfolio by investing in well-capitalised banks, protecting against potential economic downturns and interest rate volatility.

Strong Growth Potential

With interest rates potentially declining, growth-oriented banks expanding into high-growth areas such as fintech, digital banking, or emerging markets could outperform. These banks will likely benefit from increased customer acquisition, higher transaction volumes, and the scaling of new financial technologies.

Example Investments: Look for banks that are investing heavily in technology, have a strong presence in growing economies, or are innovating within the banking sector, particularly those that are leveraging digital transformation to expand their market share. To capture higher growth rates, invest in banks that rely on traditional banking income and expand into new, high-growth areas that can drive future profitability.

Priced In Sector Drivers

Current Interest Rate Environment

As of mid-2024, the Federal Reserve has been navigating a delicate balance between controlling inflation and supporting economic growth. Over the past few years, the Fed has aggressively hiked interest rates to their highest levels in over two decades to combat persistent inflation. These rate hikes have been instrumental in reducing inflation, which recently fell to its lowest level in three years, with consumer prices rising just 2.9% year-over-year in July. The cooling of inflation has increased speculation that the Fed will begin cutting interest rates as early as its September 2024 meeting. Many economists predict a 25-basis-point rate cut, with the potential for consecutive cuts in the following months.

Two Main Factors Driving This Shift

1. Labour Market Concerns: A weaker-than-expected July jobs report signaled potential strain in the labour market, raising concerns about the broader economy and the possibility of a recession. The triggering of the Sahm Rule, an early recession indicator based on rising unemployment rates, has added to the fears. However, the increase in unemployment may be due to more people entering the workforce rather than a significant downturn in worker demand.

2. Inflation Cooling: With inflation on a more sustainable path toward the Fed's 2% target, the pressure to maintain high interest rates has eased.

Priced In Sector Drivers – Impact on Banks

The evolving interest rate environment and economic conditions significantly affect the banking sector. Here's how the potential rate cuts and economic dynamics could affect banks:

Net Interest Margins (NIM)

Banks' profitability is closely tied to the spread between the interest they earn on loans and the interest they pay on deposits. During periods of high interest rates, banks typically see higher NIMs, as loan rates rise faster than deposits. However, this margin could compress as rates decline, potentially squeezing bank profits. Additionally, if high interest rates start to hurt the economic outlook, it might lead to higher default rates, further lowering NIM.

Loan Demand

Lower interest rates could stimulate loan demand as borrowing costs decrease. This could increase mortgage origination, business loans, and consumer credit, providing banks more opportunities to generate revenue. However, this depends on the overall economic outlook and consumer confidence

Credit Quality:

If a recession occurs, the weakening labor market raises concerns regarding the credit quality of consumer bank loans. Should economic conditions deteriorate further, there could be a significant increase in loan and credit card delinquencies and defaults.

Regulatory Scrutiny and Capital Requirements:

In a more volatile economic environment, regulatory bodies may increase scrutiny on banks, particularly in capital adequacy and risk management areas. Banks will need to ensure they maintain strong capital buffers to withstand potential economic downturns.

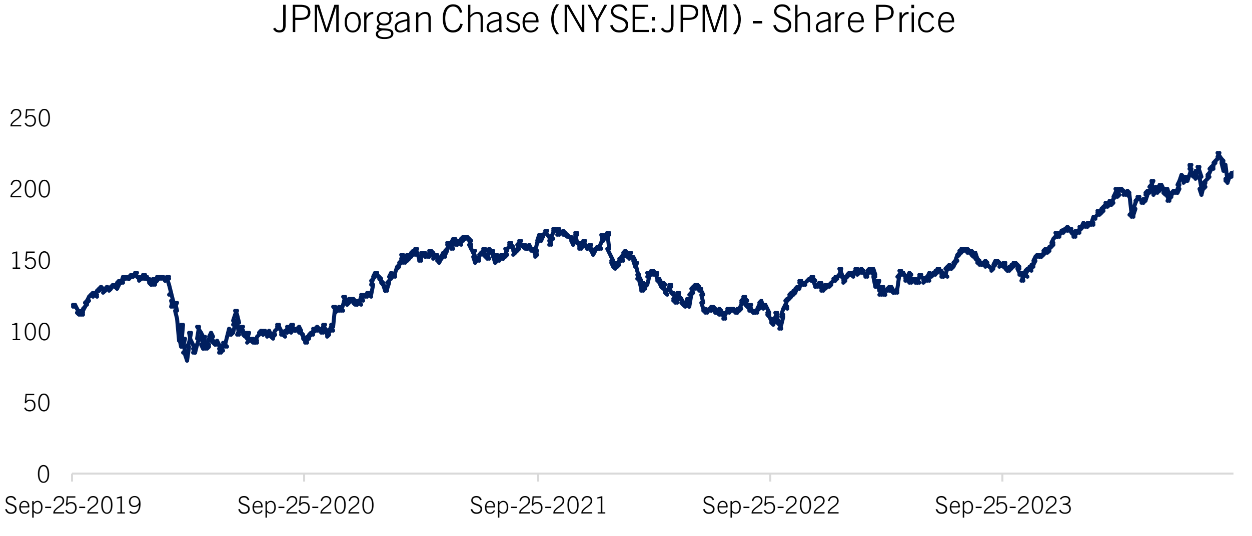
This changing environment presents both challenges and opportunities for banks. While declining rates may compress margins, they could stimulate loan demand and M&A activity. However, banks must navigate potential risks, particularly in credit quality, and ensure they are well-positioned to manage the uncertainties ahead. By focusing on risk management, balance sheet optimisation, and customer engagement, banks can adapt to the evolving landscape and continue to support economic growth.

Current Holdings

JP Morgan

- Entry Price - $114.58
- Price on 30/08/2024 – $222.50
- Price increase: 94.19%

Thesis Outline: Hold



JP Morgan outperformed its benchmark by an impressive 11.82% year-to-date (as at 31.07), showcasing its ability to generate strong returns for investors. Despite a seemingly uncertain economic landscape, the company has achieved a remarkable year-over-year growth in its share price of 51.12%, which reflects consistently high revenue growth, driven primarily by growth in management fees and higher brokerage activity.

There has been no change in the firm's LCR over the past year, which stands at 112%. This figure represents a relatively strong liquidity position, highlighting JP Morgan's ability to quickly liquidate assets on its balance sheet during a period of liquidity stress. However, this figure is slightly below some of its competitors, like BNY Mellon which currently lies at 117%.

JP Morgan currently boasts a CET1 (Common Equity Tier 1; a metric representing a bank's core capital, the most stable and highest-quality capital, and serves as a buffer to absorb losses and ensure a bank's stability) standard of 15.3%, up from 13.8% in 2023 NII is up $626mm YoY, mainly driven by the impact of the balance sheet mix and higher rates.

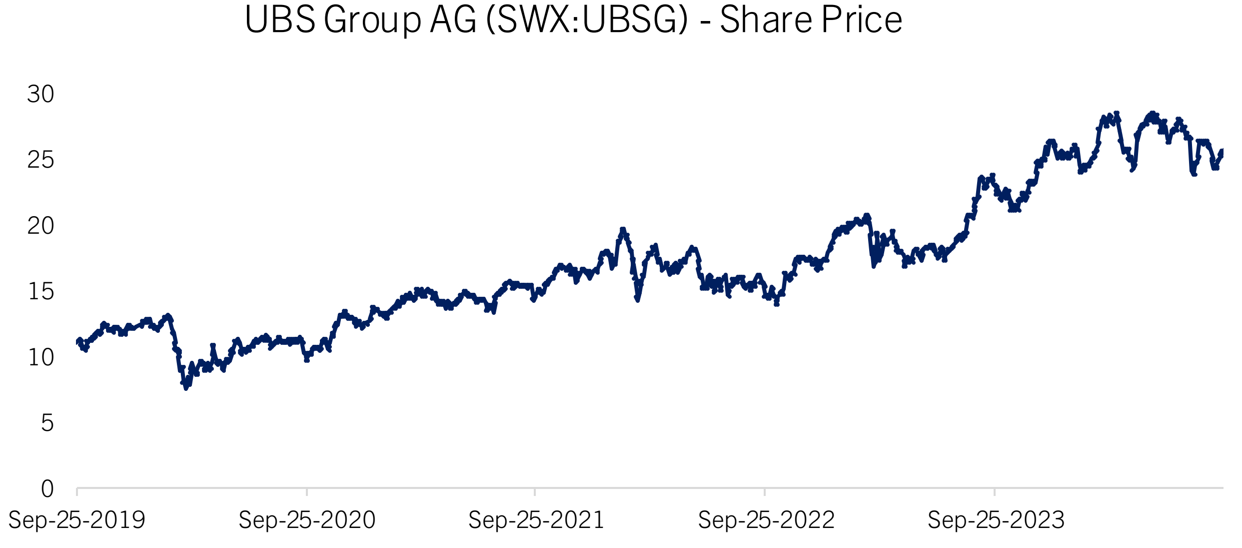
Expenses of $1.6B are up $427mm YoY, largely due to a %1.0B donation of Visa shares to pre-fund contributions to the Firm's Foundation. Average deposits of $227B are up 7% YoY due to the allocation of First Republic deposits and flat QoQ growth. With its strong market presence and high return on equity, JPMorgan Chase & Co. offers the best exposure to the U.S. banking market. Hence, holding JPM stocks is a prudent choice for us long-term.

Current Holdings

UBS

- Entry Price – CHF 22.91
- Price on 30/08/2024 – CHF 30.99

Thesis Outline: Sell



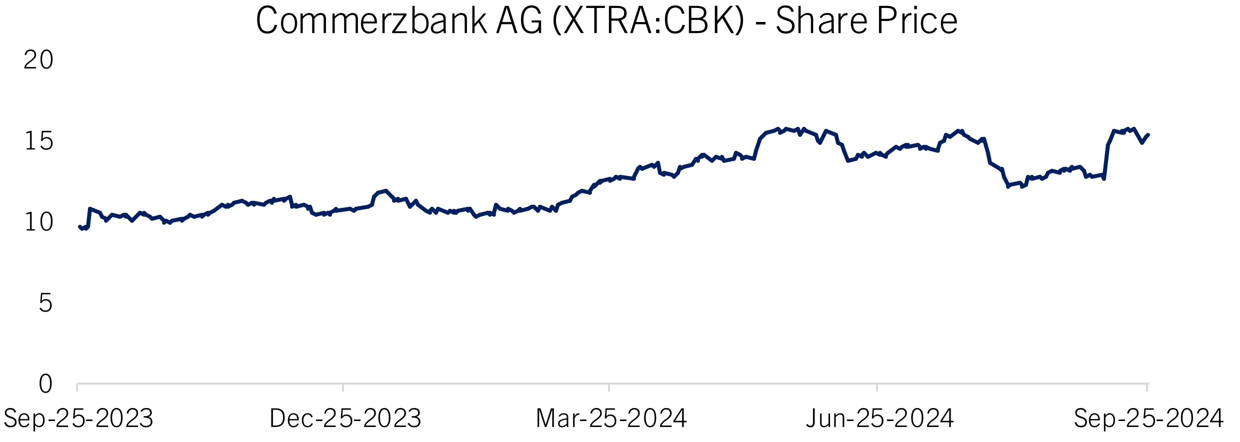
UBS underperformed the benchmark by 7.18% (as at 31.07), despite posting a YTD increase in its stock of 6.85%.UBS have maintained a strong CET1 capital ratio of 14.9%, which supports the execution of their 2024 capital return targets, share repurchases and total loss absorbing capacity. UBS have continued client momentum with net new assets of USD 27bn in Global Wealth Management.

UBS also smashed net profit expectations for the second quarter, amid cost-cutting steps and swelling revenue at the lender's global wealth management and investment bank units. UBS said strong capital markets activity had partially offset a drag from net interest income, which it had previously flagged would be weaker due to lower lending and deposit volumes and lower Swiss interest rates.

Selling UBS and opting for a bank that promises better returns could be a strategic move. UBS faces significant future capital requirements due to regulatory changes, particularly following its acquisition of Credit Suisse and the enhanced "too big to fail" regulations in Switzerland. These changes are likely to require an additional $20-25 bn in capital by 2030, which could strain UBS's profitability and dividend payouts. Although UBS is projected to have strong net income growth in the coming years, the looming capital requirements might limit its ability to generate returns comparable to other banks that are not under similar regulatory pressures. By investing in a bank with fewer capital constraints, investors could potentially achieve higher returns on their investments (5).

Case Study

Commerzbank



Commerzbank is a prominent German banking giant, is currently navigating a challenging economic landscape while maintaining a strong strategic focus on long-term growth. Both opportunities and obstacles have marked the bank's performance in recent quarters as it implements its strategy to solidify its position within the European banking sector.

The ongoing transformation is centered on enhancing profitability through a robust revenue strategy while managing costs and risks. The bank has guided for a revenue delivery of approximately €8.1 billion to €8.4 billion in 2024 and beyond, with expectations that the NII will remain resilient despite a volatile interest rate environment. Furthermore, the bank has projected an earnings-per-share (EPS) growth of 16% in 2025, with the ROTE expected to surpass 10% by 2027. These projections are based on the bank's ability to balance growing revenues and controlling costs. However, the bank's cost guidance 2025 suggests a year-on-year increase of approximately 5%, which may weigh on profitability in the near term. Despite these concerns, the cost-to-income ratio will improve to around 55% by 2027 (7).

As of August 7, 2024, the share price is €12.69, with a market capitalization of €15,029 million. The bank's sales or revenue projections are stable, with €11.5 billion expected for 2023 and 2024, rising to €12.0 billion in 2025 and €12.4 billion in 2026. Profit before tax is expected to remain around €4.2 to €4.6 billion over the forecasted period. Earnings per share (EPS) are projected to grow from €2.24 in 2023 to €2.94 by 2026, indicating solid earnings growth. The P/E ratio is expected to decline from 5.9 in 2024 to 4.3 in 2026, suggesting a potentially attractive valuation. Additionally, the dividend per share (DPS) is set to increase from €0.35 in 2023 to €1.11 in 2026, with the dividend yield rising from 3.2% to 8.7%, reflecting strong shareholder returns. The bank's return on average tangible equity is projected to maintain a steady range, highlighting consistent profitability (7).

A key challenge for Commerzbank is managing the cost of risk, which is anticipated to remain around 23-24 basis points through 2024-2026. The bank has set aside provisions to buffer against potential credit losses, reflecting a cautious approach in light of the current macroeconomic uncertainties. Additionally, regulatory pressures are a significant factor, particularly in light of the elevated market expectations surrounding the bank's strategic goals. Nevertheless, the capital management strategy remains focused on delivering substantial shareholder returns. The bank has committed to a high payout ratio, targeting over 70% of net profits in dividends and share buybacks through 2027. This commitment to capital distribution is supported by a strong CET1 capital ratio, expected to remain above 14% throughout this period, providing a solid foundation for future growth.

Commerzbank's recent performance has been impacted by a series of "speed bumps" in the near term, particularly due to higher-than-expected provisions and worsening cost guidance in the second quarter of 2024. Despite these challenges, the bank's medium-term prospects remain attractive. Management's guidance suggests NII could reach €8.4 billion by 2027, driven by tailwinds from a larger replicating portfolio and stronger lending margins.

UniCredit recently acquired a 9% stake in Commerzbank, signaling a potential step towards greater consolidation in the European banking sector. This acquisition, part of UniCredit's broader growth strategy, has boosted Commerzbank's stock and raised speculation about further collaboration or a possible merger between the two banks.

Risks

Interest Rate Volatility and Its Impact on NII

American and European banks grapple with potential interest rate cuts and volatility implications. For American banks, this could pressure net interest income, especially if loan growth does not pick up as expected. Similarly, European banks face risks from rate adjustments, where a 25 bps rate decrease, as seen in July 2024, has already led to modest reductions in NII estimates. The sector's profitability is highly sensitive to interest rate movements, and continued rate volatility could significantly impact earnings across both regions.

Rising Credit Costs and Macroeconomic Uncertainty

Both sectors are concerned about the potential increase in credit costs, driven by a weaker macroeconomic outlook. In the U.S., there is an expectation that credit losses, particularly in consumer credit and commercial real estate, may rise before stabilising. European banks are similarly worried about the potential for higher credit costs, which could result from deteriorating macroeconomic conditions. This risk is compounded by broader economic uncertainties, including potential recessions and geopolitical factors, which could lead to higher provisions for loan losses and erode profitability.

Watchlist

Commerzbank AG

(20.89% last year, 19.70% YTD) is a major German financial institution with strong ties to the corporate sector and a focus on strategic growth and efficiency.

- ROE – 10.6% (Q2 2024)
- ROA – 0.9% (Q2 2024)
- Efficiency Ratio – 56% (Q2 2024)
- P/B – 0.58x

UniCredit S.p.A.

(83.6% last year, 46% YTD) is a leading European financial services company with strong growth and profitability, recognised for its operational excellence and strategic focus.

- ROE – 19.8% (Q2 2024)
- ROA – 1.9% (Q2 2024)
- P/B – 0.92x

Bancorp, Inc.

(−1.53% last year, 2.78% YTD) is a financial services company specialising in providing banking solutions to fintech companies, wealth management firms, and specialised lending markets.

- ROE – 28.0% (Q2 2024)
- ROA – 2.9% (Q2 2024)
- Efficiency Ratio – 40% (Q2 2024)
- P/B – 1.39x

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