BlueBay
Asset Management

Where to look for income (in fixed income)?

PUBLISHED
July 2021

READ TIME
5 minutes

AUTHOR
James Macdonald
Senior Portfolio Manager

Enjoying a positive outlook despite the economic turmoil created by the pandemic, national champion banks present a rare potential yield opportunity in excess of 4% – but it won't be available forever.

Covid-19 has decimated so many industries and left economies around the globe bruised. While governments and central banks have provided unprecedented levels of support for fixed income investors, seeking out returns has become increasingly problematic.

We believe the banking sector, which has played a key role in the transmission of policy support throughout the crisis, can offer yield-hungry investors what they are looking for. The AT1 debt of large 'national champion' banks still offers yields in excess of 4%.

Going into the second half of 2021, there are three main drivers behind our positive view on the banking sector:

1. Balance sheet resilience

Despite the depth of the economic crisis, after a decade of regulatory change, banks proved their balance sheet resilience, finishing 2020 with higher levels of capital than before the crisis. Regular stress testing, transparency exercises and improvements to the ratios and quality of capital have paid dividends, ensuring banks came into the crisis in a position of strength. This enabled the sector to play a key role in tackling the crisis by keeping the lending taps open and should allow them to be beneficiaries of the post-Covid economic recovery.

"We believe the banking sector, which has played a key role in the transmission of policy support throughout the crisis, can offer yield-hungry investors what they are looking for."

An area of much debate is how non-performing loans will develop as government support measures roll-off. However, banks are already ahead on this concern and very conservatively positioned. During 2020, 40% of the provisions that banks took were for loans that continued to perform. The improvement in the economic outlook suggests banks will see the benefit of this stance over the second half of 2021 and into 2022 when these provisions can be released.

2. Earnings

For the first time in many years, we see reason to be optimistic about bank earnings. As well as the provision releases we expect to see come through, there are a number of green shoots starting to emerge.

On the income side, net interest margins appear to have troughed, success is becoming apparent in generating fees and volumes are poised to pick up as economies recover.

On the cost side, the crisis led many banks to hit pause on restructurings. As things begin to normalise, cost-saving programmes should re-emerge, boosted by many efficiencies that have become apparent during the crisis – in particular, digitalisation and the move to non-branch services. We also expect to see notably increased M&A activity, which should – in turn – reduce headcount and create greater economies of scale, offering further opportunities to improve bottom-line earnings.

3. Valuations

As central bankers focused on easing financial conditions through quantitative easing, yields have been crushed, creating a challenging investment landscape.

One of the few attractive remaining income opportunities is the AT1 subordinated debt securities issued by banks. As off-index securities, they have fallen between the cracks and, despite the attractive fundamental picture, are a rarity in offering higher returns than when we entered the pandemic early in 2020. It seems absurd that you can still pick up close to 1% in yield to invest in the securities of national champion banks – this is a more attractive return profile than what's on offer from lower-rated BB corporates.

Looking ahead

Banks entered the pandemic on a strong footing following a decade of change driven by regulatory scrutiny. Having successfully weathered the storm, we see banks as attractively positioned to benefit from the economic recovery, particularly in their position as one of a small group of sectors set to gain from any inflationary pressures that may emerge as economies recover.

As a rare remaining pocket of credit that still offers pre-pandemic levels of return, investors may need to be quick in order to capitalise on the window of opportunity this sector presents.

"As a rare remaining pocket of credit that still offers pre-pandemic levels of return, investors may need to be quick in order to capitalise on the window of opportunity this sector presents. "