Britain's banks: a bargain for value hunters

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The big four have taken a battering and there's stiff competition ahead – but right now, they're among the cheapest value stocks out there, says Charlie Morris.

Since 2008, most of the news you'll have read about British banks has been negative. It's not just due to the post-financial-crisis fallout – several other factors are squeezing banks' profits. UK banks stand to lose billions in revenue to mobile payment apps in the years ahead, says consultancy Accenture. Low interest rates are a problem too. In short, banking no longer seems to be a growth business. Yet despite these challenges, banks have something compelling going for them right now: value. Whatever challenges they face, Britain's banks are largely fixed. Their balance sheets – battered after 2008 – have been repaired. Today's share prices don't reflect that. Throw in the pounding they took after the Brexit vote and I think that banks could be one of the best value plays around right now. That has not been recognised. When it is, share prices will rise and reward those who buy in now. The catalyst for that change could be just around the corner.

Before we get to that, let's tackle balance sheets. What does a strong bank look like? Hong-Kong-based Hang Seng Bank was founded in 1933. It is majority-owned by HSBC and has a conservative reputation: it has big deposits and only lends a modest proportion of those to its customers – what's now known as "old-fashioned banking".

Between 2000 and 2009, it consistently lent out roughly 50% of its deposits. Another sign that it is a sound bank is that its deposits actually grew in 2008, as money left the weak banks and migrated to the strong. For a deeper insight, you can also look at the quality of a bank's loans and the level and quality of its capital. But this ratio of loans-to-deposits is a simple yet effective guide to a bank's strength.

By comparison, consider Northern Rock. In 2000 it was lending out 130% of its deposits – already aggressive. By the end of 2006, loans were more than 300% of deposits. Northern Rock filled the gap by borrowing short term in the money markets. That was fine until that source dried up, which resulted in the run on the bank we saw in 2007. Deposits collapsed as savers pulled their money out. Loans as a proportion of deposits peaked at 857% – then the state had to step in to rescue it. Northern Rock failed due to a liquidity crisis – the money just wasn't there. But most other UK banks were hit by a solvency crisis – loans made in the good times turned sour and the number of customer defaults ballooned. A bank is insolvent when its assets (the loans it has made and the bank's own capital – the excess reserves owned by shareholders) are worth less than its liabilities (deposits and funding).

In a bank such as Hang Seng, the difference between loans and deposits is a cushion against disaster – a strong bank has lots of scope to meet a run on deposits or to absorb bad debts. But during the good times, it's hard to be conservative – shareholders demand their capital is worked harder and an aggressive bank that makes profits on a low capital base will make higher returns on capital.

So, after 2008, UK banks had to become conservative fast. They cut lending and devoted any profits they made to recognising and writing off bad loans. It's a long-term healing process – similar credit events in the past show us that the clean up takes years. Yet it looks as though we're there now.

Take RBS, which is still nationalised and is one of the banks most closely identified with the financial crisis. At its peak, RBS's balance sheet was larger than Britain's GDP. But it has shrunk its balance sheet drastically – by the end of 2015, it was back to 2003 levels (roughly a third of its size in 2007), and deposits now once again exceed loans. That doesn't necessarily mean the bank is totally fixed – you'd also have to consider its capital base and the quality of its outstanding loans – but it does indicate that it is on a much more stable footing than it was eight years ago.

And RBS is still one of the ugliest UK banks. Judging by what it costs to insure against bankruptcy (in the credit default swap, or CDS, market), all three of the other "big four" banks – HSBC, Lloyds and Barclays – are deemed healthier by investors. In short, in balance-sheet terms, the British banks are fixed, or nearly fixed. So why do their shares continue to lag the stockmarket?

The threat from financial technology

One thing holding banks back is that the credit crisis has made people reconsider lending and money in general – and the banks face more competition as a result. Banks don't just make money from lending. They also benefit from payments and foreign exchange. When you buy lunch in Paris with a card, there's a banker sitting in London eating an extra pudding – you didn't even realise you'd ordered it. Within your lunch bill, there's the retailer's payment, the load on foreign transactions, and the foreign-exchange transaction. If it's a credit card, there is also potentially interest.

But retailers are getting their own back. Alongside financial technology companies, they are building their own payment systems. Accenture estimates that this will reduce the banks' share of the pie by a third by 2020 – at a cost of £1.45bn. Accenture's Jeremy Light told the FT that UK banks now face "a key strategic decision: whether to become a banking 'utility' supporting other providers' customer-facing solutions, or an 'everyday bank' playing a central role in customers' daily lives".

There are other threats too. For example, the Bank of England could launch a bitcoin-style electronic pound. It might sound far-fetched now, but the Bank has already written several papers on the topic. To hold those pounds, you won't need a bank account – just a piece of software aptly named a "wallet". That means custody will shift from a bank's register to an electronic, cryptographic ledger that could bypass the bank entirely. In time, this could hollow out the banks' deposit base – financial technology companies, or even insurers, could have a growing role in custody of electronic money.

These threats are one reason the market sees banks as "value traps" rather than turnaround plays. I'm not convinced. Sure, in the longer term banks will have to reinvent themselves. They have failed to keep up with technological developments, despite having the resources to take the lead. But I think valuations price this in.

Even after the internet came along, Blockbuster still had a good decade of selling highly priced popcorn and jellybeans before it became obsolete. Even if these companies are structurally ex-growth, you still have the prospect of juicy dividends, particularly give that, when the regulators ease off, dividends could recover rapidly. That's a bullish factor that the market isn't expecting.

Bonds take over from banks for savers I think there's another, more immediate, factor holding banks back – one resulting from the strange financial environment we find ourselves in. With interest rates at record lows, and confidence in banks tarnished, depositors are using government bonds as an alternative to bank deposits. Post-crisis, the return of their capital has become more important to savers than the return on their capital.

For many, zero or negative rates on government bonds are preferable to potentially risky bank deposits. Following a banking crisis, a government bond becomes the opposite of a bank. It's a recurring theme in a deflationary world. Look at Japan. It had a banking crisis back in 1990 and the Japanese ten-year bond yield fell from 8% then to -0.25% (until last week, when they neared positive territory after a sell-off).

The underperformance of Japanese bank shares has followed. Today, across all developed markets, the relative performance of bank shares has kept in lockstep with bond yields. In other words, the lower bond yields go, the more bank stocks lag the market. In both 2009 and 2012, during the post-credit-crisis recovery and the post-eurozone crisis relief rally respectively, when fears over debt deflation eased off, we saw bank shares rally as bond yields rose.

This isn't just about the impact of lower yields on banks' profits, incidentally. A bank's profitability doesn't come from the shape of the government yield curve – it comes from its net interest margins. I challenge any of you to get a ten or 30-year loan at government rates (if you can, then snap it up). If you take a look at Lloyds' net interest margin, for example, it has been rising since 2013. The main reason that UK banks have sold off post-Brexit is because of the global fall in bond yields. And if bond yields rise again, it'll be a cracking opportunity to buy the banks.

Just look at what happened last week, when the Bank of Japan "disappointed" markets by failing to print even more money to buy bonds. Bond yields saw one of their biggest jumps in the last decade and at the same time, Japanese bank stocks were the biggest risers on the market. In today's environment, bank stocks are the opposite of government bonds.

The return of inflation

So what could trigger a rise in bond yields over here? The return of inflation. Future inflation expectations in the UK are derived from gilt (UK government bond) prices. For example, at the end of last week, a ten-year gilt yielded around 0.7%, a record low. Meanwhile, a ten-year inflation-linked gilt (a "linker") pays a real (ie, after inflation) interest rate of around –1.6%. The difference between the two represents the market's best effort at forecasting inflation – the breakeven rate. That is currently 2.3%, on average, over the next ten years.

In 1992, a ten-year gilt yielded around 8%, while you could have bought linkers and enjoyed a 4.5%annualised real return, courtesy of the government. Today, demand for bonds is so high that the UK Treasury is able to issue ten-year debt to eager buyers who fully expect to lose 1.6% a year, after inflation, if they hold that debt to maturity. It has been the government's policy to engineer higher inflation to deflate the burden of debt. With real yields firmly in negative territory, that policy is starting to work.

Meanwhile, the data from jobs and wages is better than many think. According to Eurostat data, real UK wages (measured using the retail price index, which is almost always higher than the consumer prices index), began to rise in 2013. Should this continue, it's good news for working people. Real wages are also rising in the US, which is still creating 2.5 million jobs a year. You may have seen the images outside McDonald's headquarters in Chicago where employees disrupted the AGM and forced the building to close.

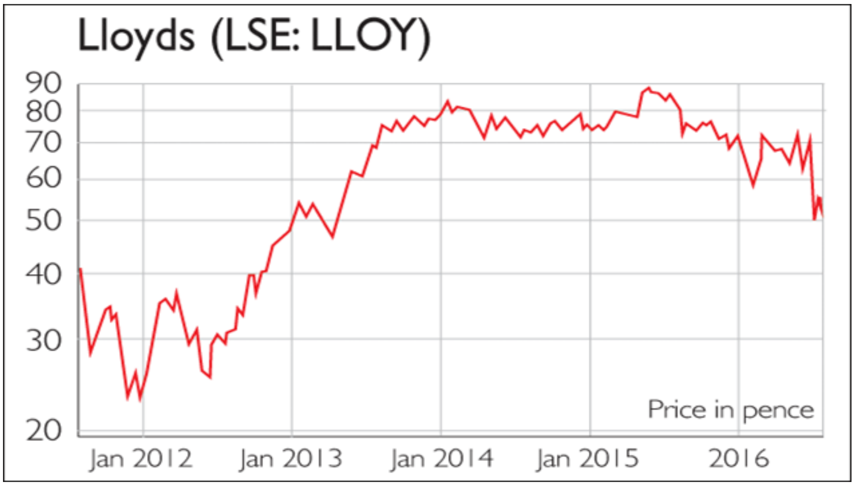
They demanded $15 an hour in contrast to the current $10.50, with improved working conditions. That incident isn't isolated and there's a whiff of the 1970s in the air – corporations are enjoying unusually high profits today, while paying out an unusually low proportion of their profits as wages. That can't last – rising wage inflation shows it's already set to change.

When inflation picks up, investors will turn from assets that benefit from deflation. So they'll ditch expensive-looking growth stocks, which benefit in deflationary times, because growth is hard to come by. They'll also move away from bonds, which will lose their appeal once it becomes clear inflation is going to eat away at fixed-income returns. Instead, they'll turn back to cheap-looking value stocks. And banks are among the cheapest value stocks out ther. I look at two of the ones I like best below.

The two banks to buy now

HSBC (LSE: HSBC) is a global bank. Roughly a third of its revenue comes from Europe and 40% from Asia. I spent 17 years working there – I know firsthand that it is conservatively run and has a strong balance sheet. That is backed up by the market's view of its default risk – its credit default swap (CDS) spread is the lowest of the UK-listed banks. Retail banking accounts for 35% of HSBC's revenue, investment banking 29% and commercial banking 21%. Its private bank makes up just 3.5% of revenues.

The shares offer good value on a price-to-book ratio of 0.65 and a dividend yield of more than 7%. The shares have lagged the fall in sterling and the longer-term trend has turned positive. The biggest risk of owning HSBC could come from a deterioration in China, continued stress in banking stocks, or a new round of regulatory headaches.



For a more domestic-oriented play, I'd go for **Lloyds Banking Group (LSE: LLOY)**. Lloyds continues to undergo an aggressive cost-cutting programme. This may be harsh on the employees, yet it is unfortunately necessary for the business to thrive. When the cost savings come through, the market may well be surprised just how profitable it is. Any sell-off in the government bond market will be the trigger to turn sentiment for the better.

When that happens, expect the good news to keep on coming. I'd add that it's not just the banks that are set to benefit from a rebound in post-Brexit sentiment and rallying bond yields – I've been looking at another attractive financial sector in more detail in my newsletter, The Fleet Street Letter.