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Chief Investment Office GWM
Investment Research

European banks hit by Ukraine tensions, but outlook remains solid

UBS House View - Daily Europe

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Thought of the day

European bank stocks have come under pressure this week amid rising geopolitical tensions. On Monday, the Stoxx 600 Banks Index fell by more than 3%,led by lenders with the highest exposure to Eastern European markets amid reports that a Russian invasion of Ukraine could be imminent (which is not our base case scenario). The index regained 1.2% on Tuesday on more reassuring headlines about Ukraine, and after a strong performance in January, the sector is still up nearly 12% so far this year, compared to a 4% decline for the Euro Stoxx 600.

But despite the recent volatility, we think European bank stocks will continue to benefit from several tailwinds.

Higher rates provide a positive backdrop for the sector: With Central and Eastern Europe and the UK early in a rate-hiking cycle, we think these regions have the greatest scope to support growth in banks' net interest income (NII) in the coming months. While we expect some moderation in mortgage lending, corporate and consumer loan volumes should gradually pick up from currently low levels, further supporting NII growth.

Operating earnings momentum remains strong: European banks' core revenue growth still exceeds cost inflation, and capital buildup continues. Meanwhile, fees and commissions are still supportive alongside the slowly improving trend in NII. Normalizing cost of risk (the ratio of provisions to loan volumes) remains a tailwind, which might support the sector far longer than previously anticipated.

Shareholder returns continue to grow: Capital returns in the form of cash dividends and share buybacks will further support the sector, as restrictions on payouts ended in September. Banks' common equity Tier 1 (CET1) capital levels are at record highs, and the sector offers high-single-digit returns for 2022. This is supported by recent comments from regulators, stressing that they do not intend to take a restrictive stance in terms of returning capital to shareholders. Overall, the sector is well

Market update

Nikkei 225 +2.0%, Japan leads regional risk-on gains.
UST 10Y yield to 2.03%, with the yield curve steepening.
Brent crude oil –0.2%, steadying near USD 93.2/bbl.

What to watch: 16 February 2022

- FOMC minutes from January Fed meeting
- US January retail sales, industrial production, capacity utilization

capitalized, offering an attractive 5% dividend yield, and it may continue to surprise positively on shareholder returns.

So we believe that valuations for European bank stocks remain attractive, especially relative to the wider market, and we expect the sector to benefit from rising bond yields and robust economic growth as has been underlined by recent positive earnings surprises. Rising rates should continue to support further upgrades. We recommend a selective approach in the sector, with a focus on banks that have a high gearing to rising interest rates and offer attractive shareholder returns at a reasonable price.

Caught our attention

- **Equities rally, oil falls on cooling Ukraine tensions...** Conciliatory signs from Russia have helped ease investor concerns over the past 24 hours, with Brent falling 4% from Monday's peaks and the Nasdaq and Nikkei 225 rallying 2.5% and 2%, respectively. In a press conference following his meeting with German Chancellor Olaf Scholz in Moscow, President Vladimir Putin said Russia did not want a war with Europe. Meanwhile, the Russian defense ministry announced that some troops were returning to base after completing military exercises near Ukraine, although the NATO secretary-general noted that he had not yet seen "any sign of de-escalation" from the Russian military. *We expect equities and oil to remain highly volatile in the very near term, with price swings driven by news flow on escalation and de-escalation. With that in mind, we see commodities and energy stocks as a good way for investors to hedge portfolio risks in the current environment. Beyond geopolitical factors, we believe tight oil market fundamentals should support further upside for crude prices over the next 12 months. OECD oil inventories are already at their lowest level since 2014, and we expect oil demand to reach a record high later this year. Against this backdrop, we look for Brent crude to reach USD 95/bbl by June and USD 100/bbl by December.*
- **.. but reports point to digital disruption.** While military and diplomatic headlines improved, reports pointed to distributed cyberattacks impacting several Ukraine institutions. Websites, payments and apps for two banks were affected, alongside at least three ministry websites. DDoS attacks are relatively basic, with services disrupted by a flood of distributed traffic. *Digital infrastructure, whether private or public, remain highly vulnerable to sophisticated cyber breaches. Rising awareness of the risks and costs of such attacks have pushed up spending on cybersecurity defenses, with the overall market growing around 10% per year. Cybersecurity is one of three foundational technologies we identify in our "ABCs of tech" investment theme, alongside artificial intelligence and big data. More here.*

Appendix

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