Global Banking Industry On An Uptrend; Yet Monetary Policy Risks Remain

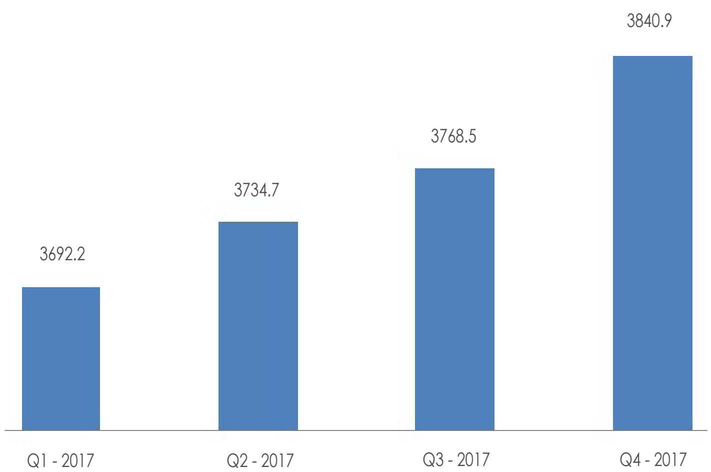
The global banking industry outlook has improved appreciably in recent quarters. With the scaling back of quantitative easing programs in most developed countries, the risk of negative interest rates has nearly disappeared. Rising income levels and average home prices continue to support consumer credit demand in most major markets. Wholesale credit demand growth remains tepid, especially in emerging economies, but there are early signs of a recovery. Net interest margins have improved, as banks have been able to limit the rise in their cost of funds even as lending rates have trended higher. Helped by the buoyant asset markets as well as increased merger and acquisition activity, trading and fee incomes have also expanded for most large banks. Nevertheless, uncertainties about future monetary policy direction as inflation risks rise with the strengthening economy could increase earnings risk for the banking industry.

KEY TAKEAWAYS

Wholesale credit demand growth remains tepid, especially in emerging economies, but there are early signs of a recovery. Net interest margins have improved, as banks have been able to limit the rise in their cost of funds even as lending rates have trended higher.

Investors across most major markets were attracted to banking and financials stocks in 2017, and the trend has continued at the start of this year as well. Banks are now well accustomed to tighter regulatory controls, a major headwind for global banks after the 2008 financial crisis. Provisions for

Consumer credit growth in the U.S.



Total consumer credit outstanding (seasonally adjusted, in billions of USD)

Data source: U.S. Federal Reserve

financial penalties related to past misconduct have steadily come down, and should end for most banks in the near term. In select countries, such as the U.S., the prospect of a lighter regulatory regime and lower compliance costs remain. Their balance sheets are in far better shape, with relatively healthy capital ratios and reserves.

In recent quarters, earnings growth for banks and financial services companies have been on an uptrend. Banks across most regions have reported healthy earnings expansion. In the developed markets, margins have improved as interest rates have started hardening gradually. As the developed economies are in good shape, with high consumer confidence, banks are able to lift their lending rates while at the same time keep their cost of funds under control. Their fee incomes have also increased, compared to recent years. Though many banks continue to face challenges in trading operations, increased mergers and acquisitions as well as other transactions have lifted their fee income. Even Italian banks, laggards when compared to their regional peers, have started increasing dividend payouts.

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Uncertainties about monetary policy direction in the U.S., and to a lesser extent in the Eurozone, are likely to be a major risk for the banking industry this year. Aggregate economic growth has been stronger than expected, though wage growth and inflation remain tepid. However, further tightening of the labor market could accelerate wage gains and lift inflation risks. Additional fiscal spending, which is more likely in the U.S. than Europe, could worsen this risk, despite the positive effect on short-term growth. In that scenario, the U.S. Federal Reserve would likely be forced to accelerate rate hikes and lighten its balance sheet earlier than currently expected. The European Central Bank has repeatedly emphasized its reluctance to hike its benchmark rate before the second quarter of 2019. Nevertheless, negative inflation surprises could test that commitment. The Bank of Japan is likely to continue its quantitative easing measures as current inflation is farthest from target in Japan, compared to other developed countries.

In emerging countries, credit demand appears to be brightening with improving economic growth. Most major banks remain confident about continued gains in consumer lending. The growing popularity of financial assets, as against physical assets such as real estate, and insurance products in emerging countries is helping banks boost their income from financial services. Most central banks are expected to hold their benchmark rates stable, or implement modest rate hikes, which should help interest margins. Banks in several emerging countries have seen a spike in loan losses in recent years, as several industries hit cyclical troughs. This pressure on the bottom line should ease in the coming quarters, as most of the economies have turned the corner.

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