COMMENTARY

October 18, 2019

Dear clients and colleagues:

In recent weeks some weak macroeconomic data points have resulted in the re-emergence of concerns about the global macro outlook. Germany's PMI fell below the 50 threshold for the first time since April 2013 and the US Manufacturing PMI also proved disappointing, falling to 47.8 in September, its lowest level since June 2009. In addition, a range of macroeconomic risks still prevail.

As a consequence of weaker growth and inflation expectations, central banks are reverting to additional monetary reflation with more quantitative easing and lower interest rates. This was demonstrated by the latest European Central Bank (ECB) policy, which saw deposit rates in Europe pushed down further to -0.5% and quantitative easing set to resume in November at €30 billion. The Bank of England (BOE) could follow its European counterpart in 2020 as a UK interest rate cut is already being priced in by the market.

Real interest rates have fallen worldwide, and have been doing so steadily for the last 20 years. This is a secular phenomenon. Although lower interest rates are a burden for banks, their profitability can be somewhat protected by higher volumes and a lower cost of risk. As a result, banks have been underperforming in recent years.

An orderly, no-deal Brexit has been almost entirely priced in to stock prices across the board, but banks have been the worst performing industry group year to date. Only the automobiles and components industry group performed worse in some markets. As central bank monetary policies are currently more reflationary, the banking industry is likely to remain under pressure.

Since the beginning of the year, our underweight positions within banks have had a positive impact on our International portfolios. We believe that despite a challenging environment, regulatory risks and negative interest rates, domestic banks operating in niche markets could outperform their peers.

OneSavings Bank (OSB) stands out in the tough banking sector. The stock has outperformed both its peers and the MSCI EAFE Small Cap Index since the beginning of the year.

OSB is a leading UK challenger bank, focusing on the professional landlord buy-to-let market in the UK. Despite some margin pressure, we believe that OSB is one of a few banks that could deliver good top- and bottom-line growth while maintaining an above average return on equity. Following its merger with Charter Court, the new entity will be one of the UK's largest specialist lenders with a combine market share of 6%. The new group is expected to benefit from a better-diversified loan book and a more varied source of funding. The cost synergies realized from the merger should offset the higher insurance costs. We also believe OSB could derive revenue synergies to support loan growth in this underserved segment of the lending market.

Specialist lenders can benefit from relatively stable mortgage approvals. The buy-to-let segment posted a growth of 5.5% this summer compare to 2018. Wage growth and lower interest rates are all favourable factors supporting this growth.

Easing trade and Brexit uncertainty could drive equity inflows back to Europe. In case of a positive Brexit outcome, UK domestic stocks, including banks, should outperform.

Have a great weekend.

The Global Alpha team