UBS Global I/O

Global Banks Reality Check
A preference for EM banks over DM banks

Equities

Global
Banks

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Q4 in-house survey – improved sentiment in emerging markets

As we enter the final quarter of the year, sentiment towards the banking sector has improved slightly with 35% of respondents in our global in-house banking survey positive on the banking outlook (up from 33% a quarter earlier) versus 33% with a cautious view. The improvement in overall sentiment was driven by emerging market (EM) banks where 36% of respondents have a positive view (up from 33%), while the positive stance for developed market (DM) banks was unchanged, at 33%.

DM: Better fundamentals; NIM pressure remains key risk

In DM, the banking picture has improved slightly in the quarter with prospects for loan growth and NPL prospects better, albeit still skewed to the downside. The key area of risk remains net interest margins (NIM) where 47% of respondents see downside risk versus 20% that see upside potential, although the risk to earnings is now balanced. Downside earnings risk is seen in Australia, Germany and Japan, while upside risk is seen in Austria, Spain and the US (brokers and universal banks).

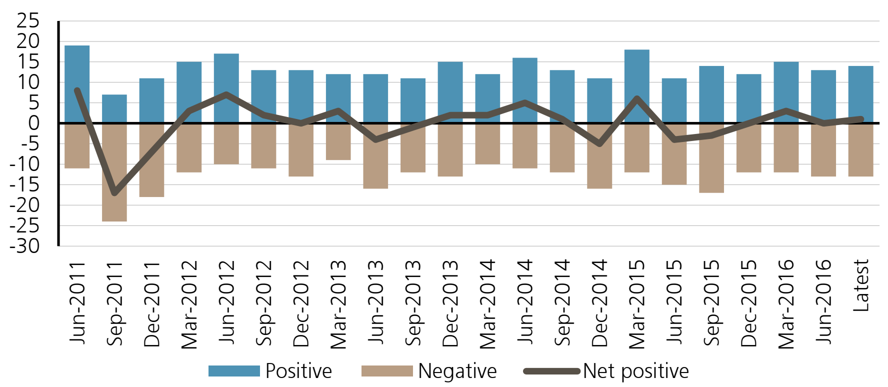
EM sentiment better; NPL/earnings inflection?

In EM, sentiment improved further – the first time since March 2015 that it was not negatively skewed. Expectations also improved on loan growth with 24% seeing upside risk (from 17%) and NIM (24% see upside risk from 21%). Furthermore, for the second consecutive quarter, NPL risk has been positively skewed with 40% seeing lower NPLs versus 24% seeing upside risk. In the past three months, earnings momentum has turned positive, culminating in 2016 ROE rising to 15.1% from 14.5% three months earlier.

Headwinds to persist; preference for EM over DM

While sentiment towards the sector has improved slightly, earnings momentum remains firmly negative (over the past 12 months, we have cut sector EPS estimates by 16.1% (2016) and 18.4% (2017)) with the key driver being margin pressure – a risk considerably greater in DM. Reflecting our survey findings, we reiterate our preference for EM banks over DM banks, and within DM, our preference for US banks over EU banks. Top picks: BRI, Citizens, ING, Itau, HDFC Bank, Key, Lloyds, MUFG, Sberbank and Westpac.

Figure 1: Evolution of UBS global banking analysts' outlook over time



Source: UBS estimates

UBS Research THESIS MAP

MOST FAVOURED

BRI, Citizens, ING, Itau, HDFC Bank, KEY, Lloyds, MUFG, Sberbank, Westpac

LEAST FAVOURED

CIB, Commerz, Deutsche, Handelsbanken, NAB, Komercni, Standbank, Wells, Zions, Yes

PIVOTAL QUESTIONS

Q: Are central banks running out of policy tools to boost lending?

Central banks globally have cut policy rates, and undertaken asset purchases and other lending initiatives, yet credit demand remains anaemic. Other policy measures, such as negative interest rates in Europe, Japan and Sweden, have lowered asset yields, and put pressure on margins and profitability. It is unclear what alternative policy tools are left for policymakers to stimulate economic growth.

Q: What could "Basel 4" rules mean for banks?

The Basel committee is expected to publish a proposal, possibly by early next year, outlining revisions to the standardised approach to credit risk and capital floors related to risk-weightings derived from IRB models, in an attempt to harmonise credit risk weightings. An analysis of credit risk weightings suggests risk weighted asset (RWA) density is lowest in Europe (ex UK) at 34% and Japan (32%), and highest in the US at 67%.

Q: Have EM banks' NPLs and earnings reached inflection points?

According to our 4Q16 in-house banking survey, we are seeing an inflection point in the NPL outlook for EM banks, after three years of pessimism, with 40% of respondents seeing lower NPLs versus 24% seeing upside risk. In the past three months, we have also seen positive earnings momentum among EM banks, culminating in 2016E ROE rising to 15.1% from 14.5% three months earlier.

WHAT'S PRICED IN?

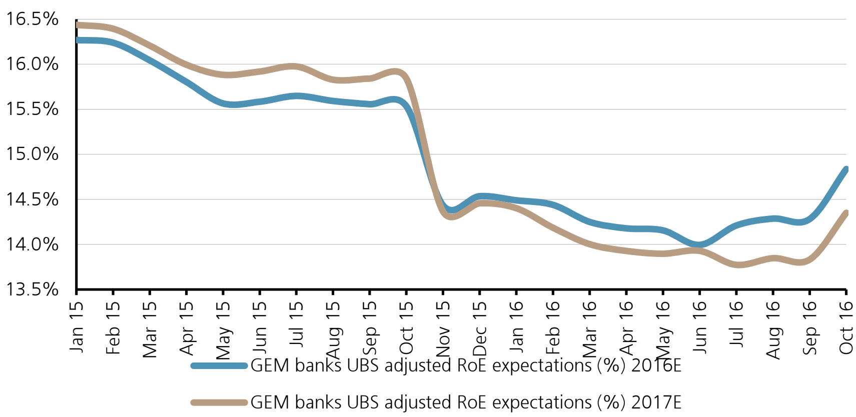
Current valuations suggest the market is expecting a 14% fall in earnings: The market remains concerned about the sector earnings risks (year-to-date, our 2016 EPS estimates for global banks have been downgraded already by an average of 6.4%) and appears to be pricing in a 14% fall in earnings next year. Looking ahead, we believe this risk is highest in developed markets, given ongoing margin pressure from prevailing policy rates.

UBS VIEW

The fundamental outlook for banks continues to be challenging. Our latest in-house survey finds that margin risk remains to the downside and loan growth expectations continue to be negatively skewed, although NPL expectations have improved, notably in emerging markets. While global sector performance this year has been poor (down 4.2% in US dollars year-to-date), until we see evidence of positive earnings momentum (notably in DM), we are unlikely to become constructive.

EVIDENCE

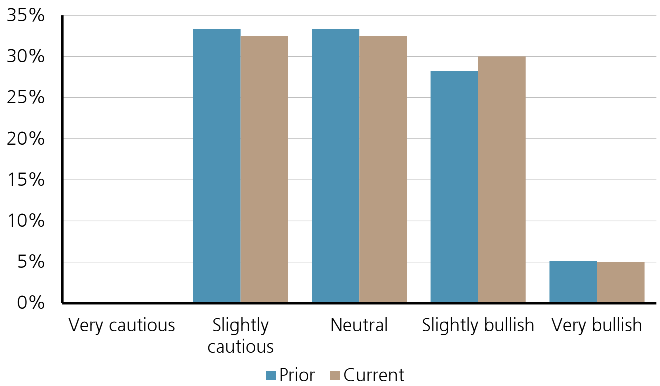
EM banks' ROE expectations



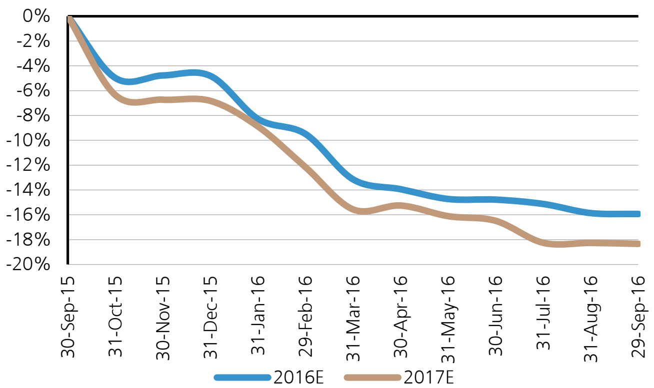
Source: UBS estimates

OUR THESIS IN PICTURES

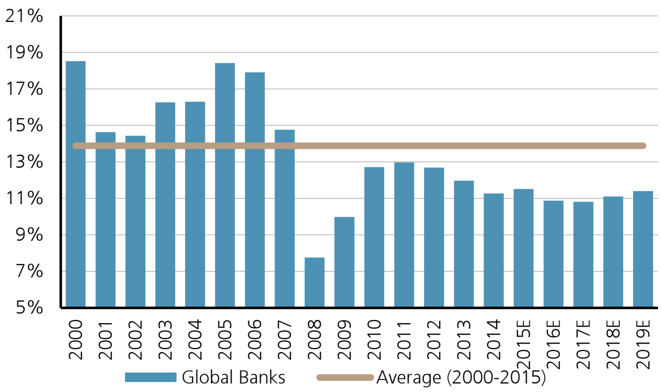
return ↑



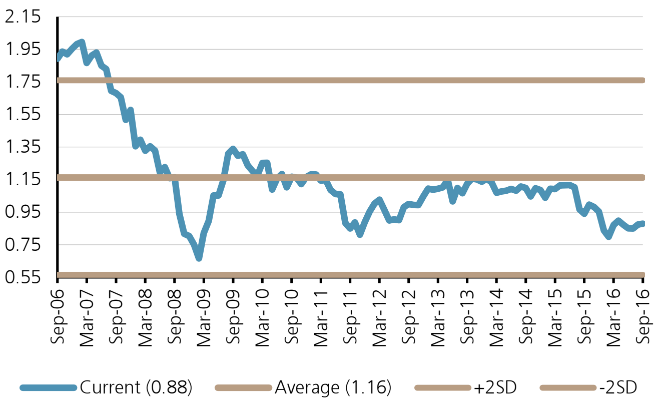
Our latest banking survey shows sentiment towards the banking sector is slightly more positive than previously



Over the past year, UBS 2016 EPS growth expectations for global banks have come down by 16.1%, while those for 2017 have fallen 18.4%



Global banks' ROE has declined over the past five years. RoEs are currently forecast by UBS at 10.9% in 2016 versus an historical average of 13.9%



Reflecting falling ROE expectations, based on consensus estimates, global banks now trade at 0.85x (1-year forward) PBV – well below the historical average of 1.16x PBV

Sources for exhibits above: UBS, I/B/E/S MSCI Aggregates, Thomson Financials DataStream

Executive summary

Sentiment skewed slightly positively

According to the results of our latest in-house banking survey, sentiment towards the banking sector is almost unchanged since our last survey and remains skewed slightly toward being positive. In our last survey, there had been a notable deterioration in DM sentiment post the UK Referendum. Since then, the Federal Reserve has been reducing rate hike expectations, the Japanese central bank has announced more unorthodox policy measures to try to invigorate inflation and growth, while, in Europe, the ECB is adamant that QE tapering is not on the cards despite recent media chatter.

Given further policy measures, sentiment towards banking outlook slightly more positive

While the percentage of respondents with a positive view on the sector outlook climbed slightly to 35% (33% a quarter earlier), this only marginally exceeds the percentage of respondents with a cautious view (33%). The positive skew was driven by the 5% of respondents holding a very bullish stance, while no respondents currently hold a very cautious view.

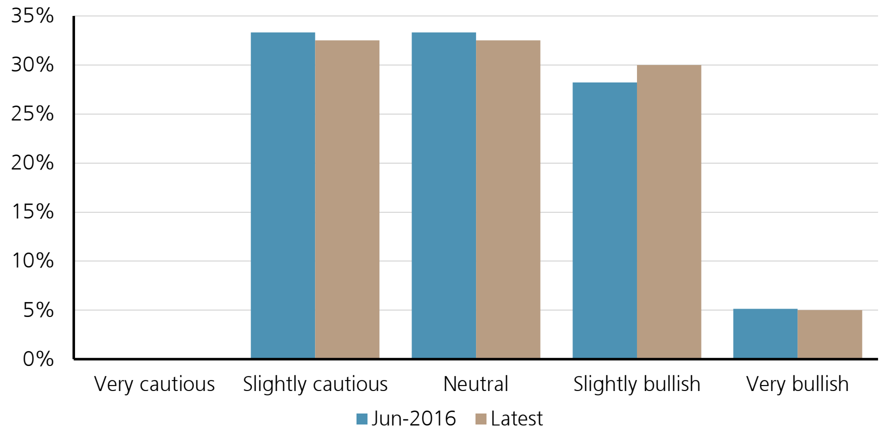
Developed market outlook is slightly positive

In developed markets (DM), sentiment remains skewed slightly positive. The proportion of respondents with a negative view remains at 27% (unchanged from the previous survey), while respondents with a positive outlook also remained at 33%. As in our previous survey, there are no respondents with a very bullish view. By country, we are slightly cautious on Australia, Austria, Germany and Spain, while we are slightly bullish on Benelux, France, Italy, Nordic and the US (regionals).

In DM, we are slightly cautious on Australia, Austria, Germany and Spain…

…but slightly bullish on Benelux, France, Italy, Nordic and the US (regionals)

Figure 2: What best describes your view on the outlook for your sector?



Source: UBS estimates

EM outlook better, now neutral

In EM, the number of respondents with a negative view improved to 36% from 38% in the previous survey, while the number of respondents having a positive view on the outlook also improved to 36% (previously 33%), including 8% of respondents now having a very bullish outlook (previously none).

After three years of negative sentiment, we now have a neutral stance on EM banks

Countries showing notable positive changes in sentiment include Brazil (upgraded to overweight), given expectations of a turnaround in macro indications, progress on economic reforms with the focus on a cap on government spending, and early signs of improvements in asset quality. In addition, we are more constructive on Hungary where we are now very bullish after previously being slightly bullish, due to a solid macroeconomic environment, a restarting credit cycle and low CoR, given strong deleveraging.

Upgrading Brazil to overweight; very bullish on Hungary…

In contrast, we have become more cautious on banks in the Czech Republic where we are now slightly cautious (weak fee income and rising provisions). We would also highlight Mexico, which we have downgraded one notch to neutral – the first time that we have been neutral on Mexico since March 2012. Our less constructive view on Mexican banks is primarily driven by external factors, such as Peso weakness and our expectations for valuations as we approach the US elections on 8 November, while we believe banking fundamentals remain sound.

…but more cautious on Czech, and now neutral on Mexico

Views on fundamentals

Loan growth expectations have improved, but remain skewed to the downside

- **Loan growth expectations have improved:** The overall picture for loan growth has improved somewhat compared with the previous survey, but is still skewed to the downside. In this survey, 20% of respondents (previously 10%) believe there is upside risk to loan growth forecasts, while 25% (previously 49%) believe there is downside risk.
  - **In developed markets,** there has been a sharp reduction in the proportion of respondents seeing downside risk to loan growth (20% compared with 73% previously), along with a considerable increase in the number of respondents seeing upside risk (to 13% from 0% previously), albeit the outlook remains skewed to the downside. Developed markets where downside risk is perceived are Australia, Switzerland, and the US (regionals), while upside risk is seen in Austria and Spain.
  - **In emerging markets,** there has been a small improvement in the proportion of respondents seeing upside risk to loan growth (24% compared with 17% previously), while the percentage of respondents seeing downside risk has declined to 28% (versus 33% previously). Upside risk to loan growth is expected in Argentina, China, Colombia, Hungary, Peru and Philippines, and downside risk in Georgia, Indonesia, Malaysia, Singapore, South Africa, Thailand and Turkey.

NIM risk still skewed to the downside, reflecting falling rate expectations and the prospects for more QE

- **NIM outlook still skewed to the downside:** In our latest survey, only 23% of respondents see upside risk to NIMs, versus 33% who see downside potential. This compares with a more negative outlook in the previous survey, when 15% of respondents expected upside potential, while 46% saw downside risk.
  - **For developed markets,** the view remains skewed to the downside, with 20% of respondents seeing upside risk to NIMs (7% previously) but 47% seeing downside risk (previously 60%). Developed markets seeing upside risk to NIM are Israel, US brokers and US regionals, while those seeing downside risk include Australia, Germany, Ireland, Italy, Japan, Spain and Switzerland.
  - **In emerging markets,** the outlook is balanced with 24% of respondents seeing downside risk to NIMs (compared with 38% in the previous survey), while 24% see upside risk (versus 21% previously). EM respondents seeing

downside risk are in Argentina, Chile, Czech Republic, India, Malaysia and Thailand, while respondents seeing upside risk are in China, Colombia, Kazakhstan, Mexico, Philippines and Singapore.

- **Better NPL expectations:** Expectations on the outlook for NPL levels have improved slightly, and are now positively skewed, with 23% (versus 38% previously) seeing the risk of higher NPLs, versus 30% seeing downside risk (33% previously).
  - **In developed markets,** the aggregate picture has improved, but remains negative with 20% (versus 53% previously) of respondents seeing the risk of NPLs being higher than currently forecast, and 13% seeing downside risk (previously 20%). In the survey, we see higher NPL risk in Australia, Spain, and the US (regionals), and lower NPL risk in Austria and Ireland.

20% of DM respondents see the risk of higher NPLs

  - **In emerging markets,** respondents are now positive in their view of the outlook for NPL levels, with 40% seeing downside risk to forecast NPLs (42% previously) and only 24% (29% previously) seeing upside risk. Downside risk to NPLs was seen in Brazil, Chile, Colombia, Hungary, India, Kazakhstan, Mexico, Peru, Poland and Thailand, while upside risk was seen in the Arab Emirates, Korea, Malaysia, Singapore, South Africa and Turkey.

In EM, we are seeing an inflection point in the NPL outlook, after three years of pessimism

- **Earnings risk now more balanced:** Our analysts are now balanced on risks to earnings forecasts in aggregate for the next 12 months, with 28% seeing upside risk to earnings forecasts and 28% seeing downside risk. Overall, this is a significant improvement compared with the previous survey, where 23% of respondents saw upside risk to earnings and 33% saw downside risk.

Respondents see earnings risk equally balanced

  - **In developed markets,** the earnings outlook has improved and is now balanced with 20% seeing upside risk (previously none) versus 20% seeing downside risk to earnings (from 47% previously). The downside risk is seen in Australia, Germany and Japan, and the upside risk is seen in Austria, Spain and the US (brokers and universal banks).
  - **In emerging markets,** 32% of respondents now see downside risk to earnings (compared with 25% in the previous survey), while 32% see upside risk (38% previously). Upside risk is anticipated in China, Colombia, Georgia, Hungary, Kazakhstan, Mexico, Peru and Russia, while downside risk is seen in the UAE, Argentina, Czech Republic, Malaysia, Singapore, South Africa, Taiwan and Thailand.

Views on valuations

Global banking sector performance has been highly volatile, staging a significant rally in Q3. Since the start of 2016, the global banking index is down 4.2% (in US dollars), underperforming global equities by 8.3%. In 2015, global banks were down 11.8%, underperforming global equities by 7.9%.

Given this, the majority of respondents considered their covered banks to be either fairly valued (60%, versus 33% in the previous survey) or cheap/very cheap (35%, down from 59% previously).

The sector is largely considered to be between fair value and/or cheap

Investment strategy

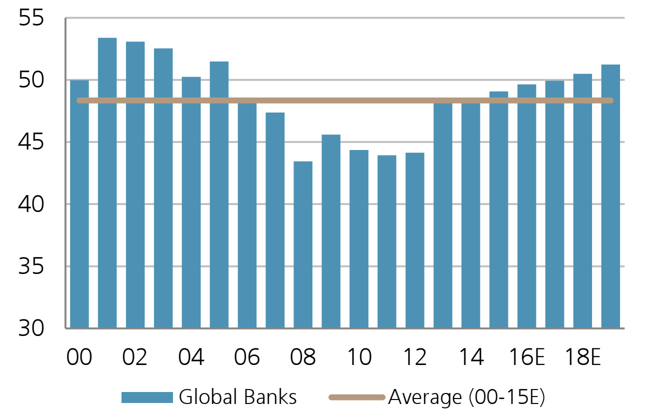
Two key themes for banks: deflation risk and Basel IV rules

As we move into the fourth quarter of the year, challenges to the banking sector look set to persist. Two key themes dominate the sector: (1) the implications of global deflation for bank margins, as policy makers struggle to stimulate inflation and growth; and (2) renewed regulatory risk, notably regarding credit risk weightings, informally referred to as Basel IV.

Policy announcements by the Bank of Japan (BOJ) and the Federal Reserve suggest global deflation continues to be a key policy concern. In Japan, it remains to be seen how stable the yield curve will be following the BoJ's recent change in its policy framework to control the yield curve, while in the US, rate expectations appear to be coming down with the Fed hinting at a much more dovish outlook for short-term rates.

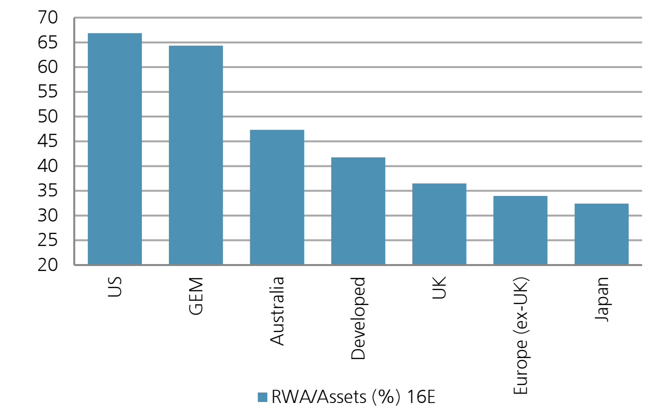
In Europe, despite media chatter, the ECB is adamant that QE tapering is not on the cards, although it has yet to confirm an extension to the current €80bn/month bond-purchase programme, due to finish in March 2017. From a bank fundamental perspective, deflation and/or a prolonged period of low-inflation/low-growth implies further pressure on bank margins as well as subdued credit demand, undermining the earnings power of the banking industry.

Figure 3: Global banks RWA/assets trends (%)



Source: UBS estimates. Note: Based on aggregated US$ RWA and asset values for the UBS banking research universe

Figure 4: Regional RWA/assets comparison (%)



Source: UBS estimates. Note: Based on aggregated US$ RWA and asset values for the UBS banking research universe

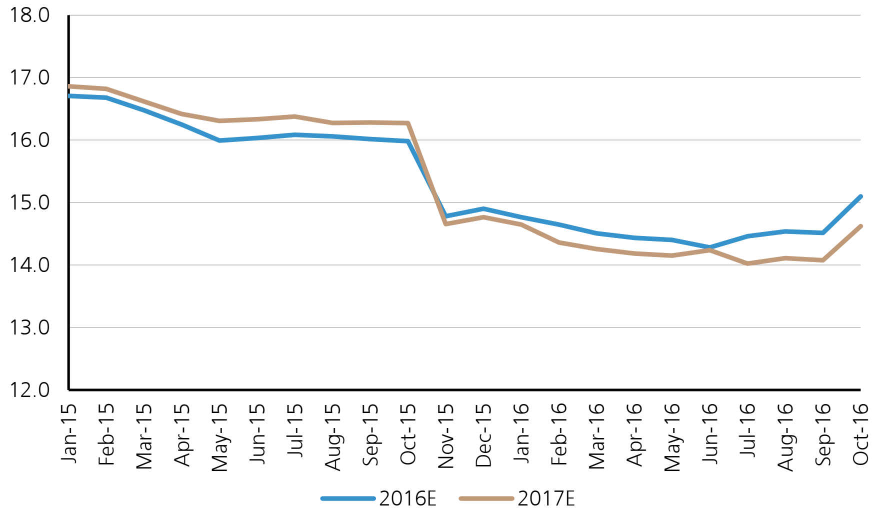
On the regulatory front, the key focus relates to the inconsistencies in the credit risk weightings used by banks in different parts of the world to calculate core capital ratios. The Basel committee is expected to publish a proposal, possibly at the year-end or early next year, to revise the standardised approach for credit risk and capital floors related to risk-weightings derived from IRB models, in an attempt to harmonise credit risk weightings.

Our latest in-house survey shows sentiment towards the banking sector has remained almost unchanged following a notable deterioration in the previous quarter post the UK Referendum, although the fundamental outlook has improved slightly with earnings risk now more balanced. Notwithstanding this, earnings momentum for global banks has remained in negative territory: over the past 12 months, we have cut our estimates for the sector by 16.1% for 2016 EPS and 18.4% for 2017 EPS.

A key driver for these downgrades has been margin pressure arising from the prevailing interest rate environment, with the risk considerably greater for banks in developed markets. While EM banks also face challenges, fundamentals appear to be under less pressure with the survey suggesting a favourable NPL outlook for the first time in three years. In the past three months, we have also seen positive earnings momentum among EM banks, culminating in 2016 ROE rising to 15.1% from 14.5% three months earlier. As such, we now have a relative preference for EM banks over DM banks.

EM banks are returning to positive earnings momentum

Figure 5: EM banks – an inflection in ROE expectations? (%)



Source: UBS estimates

A preference for EM banks over DM banks

EM banks: An inflection point in the NPL outlook

In our last quarterly publication, we upgraded EM banks from underweight to neutral within a global banking benchmark. While we have yet to go overweight, we do have a clear preference for EM banks over DM banks. Fundamental headwinds persist with credit demand remaining fragile, but we are encouraged by our in-house response on asset quality that suggests an inflection point in the asset quality outlook for the first time in three years. In other words, while EM banks have yet to move into a new credit cycle that would make us constructive on the sector, the late-cycle characteristics that have been weighing on sentiment and profitability have started to ease.

Sector valuations have been depressed for a while, but with fundamental concerns easing, we think they are now more realistic. The sector trades on 7.6x PE, 1.0x PBV with ROE at 15.1%, based on 2016 estimates. Adjusted for Chinese banks that trade on even more depressed multiples, skewing EM bank valuation aggregations, the sector trades on 11.3x PE, 1.3x PBV with ROE at 14.6%, which we view as fair. Moreover, as the developed market world moves towards lower rates and deflation, EM banks' 2016E dividend yields of 3.8%, backed by a strengthening currency, could also appeal to investors in their search for yield.

Upgrading Brazilian banks to overweight; also overweight in Russia, Hungary, Indonesia and India…

At the country level, we **upgrade Brazilian banks** to overweight (from neutral), given expectations of a turnaround in macro indications, progress on economic reforms with the focus on a cap on government spending, and early signs of improvements in asset quality. We are also overweight banks in Russia (improving asset quality and higher oil prices), Hungary (resumption of loan growth, lower

rates/COE), Indonesia (improving macro conditions bode well for asset quality), and India (NPL close to peaking with recognition accelerating).

...but downgrading Mexican banks to neutral; cautious in Argentina, Czech, Malaysia, Korea and South Africa

In contrast, we **downgrade Mexican banks to neutral** from overweight in light of uncertainties over the US elections and FX volatility that could weigh on sector fundamentals. We are also underweight banks in the Arab Emirates (higher deposit costs from oil price volatility, COR at cyclical lows), Argentina (NIM pressure, falling ROE), Czech Republic (weak fee income and rising provisions), Korea (heavy NPL pressure, Basel 4 capital constraints) and South Africa (weak macro/fundamentals). Our list of most preferred global banks features four EM banks: **Itau, Sberbank, BRI** and **HDFC Bank**.

Remaining underweight on European banks

We reaffirm our underweight stance on European banks, given continued headwinds to margins and earnings arising from the prevailing low growth/low inflation environment. Despite the recent steepening of the yield curve, risk-free rates are still low, suggesting to us that the re-investment of sovereign bond positions at today's rates will affect forward earnings, so that consensus expectations of a rebound in NII next year is too optimistic (see Jason Napier's publication No country for loan men II).

We see no evidence that regulation is going to be relaxed (see Daniel Brupbacher's What if Basel 4 is not an 'ugly rumour'?) and few signs that bank sector valuations already discount the capital deficit that would emerge if the current proposals were enacted, as underpinned by the latest market concerns over Deutsche Bank (Short-term headwinds intensifying).

Earnings momentum in Europe is not only the weakest globally, but continues to fall further into negative territory. Over the past 12 months, our European banking team has cut its 2016E EPS by 29.7% and that for 2017E by 30.9%. Given prospects of further top-line revenue pressure at a time when banks are already struggling to deliver on existing cost commitments, we see more downside risk to earnings estimates, as highlighted in our latest in-house banking survey. We maintain the same three European names in our global banks least preferred list: **Commerzbank**, **Deutsche** and **Handelsbanken** while we have also added **Standard Chartered**.

Figure 6: Global banks – regional preferences

Figure 7:

Region	Rating	UBS comments
US	Overweight	GDP growth to recover in 2017, superior to most developed countries, with more rate hikes expected.
		Stress test/CCAR underlines balance sheet strength and capital returns upside.
		Preference for regionals over brokers/universal banks; top picks: KEY (fee revenue cushion); Citizens Financial (earnings recovery).
EM	Neutral	Macro uncertainties persist, but Fed hike likely to be more modest; FX gains, while banking yields more attractive in EM.
		Loan growth expectations still coming down, but inflection point in NPLs/provisions outlook, culminating in positive earnings momentum
		O/W: Brazil, Russia, Indonesia, Hungary and India; U/W: Argentina, Czech Rep, Korea, South Africa, and UAE.
Japan	Neutral	Focus on BOJ's yield curve policy, and implications for macro growth and banks' margins/earnings.
		Credit cost to remain low, but NIM pressure from rate policy; stable dividends by improving pay-out ratios
		Sector fairly valued. Top pick: MUFG (revenue diversification).
Australia	Neutral	Housing credit growth coming off its peak, with margin pressure from increased competition; asset quality remaining benign.
		Banks likely to face further capital raises in 2017 following announcement of Basel 4.
		Flight to safety: attractive yields; preference for mortgage lenders – top pick: Westpac.
Europe	Underweight	Prevailing low/negative rates weighing on NIM/earnings outlook.
		New rules on credit risk weightings (Basel 4) likely to raise renewed balance sheet uncertainties.
		Further EPS downgrade to depress valuations. Least preferred stocks: Commerzbank, Deutsche and Handelsbanken.

Source: Source: UBS estimates

Overweight US banks

A preference for regionals over brokers

We remain overweight US banks with a preference for regional banks over brokers and universal banks. Given increasing market optimism over the interest rate outlook on the back of improving macro data, prospects for bank interest margins are more supportive and compare favourably with those in other regions. Although C&I growth is slowing, consumer lending is improving and with higher rates, underpinning the revenue picture, while asset quality continues to be benign. Costs will remain an important focus area with more banks expected to announce cost reduction programmes in an effort to bolster efficiency. Overall, we think earnings risks for US banks have receded with the forthcoming 3Q16 results likely to meet earnings expectations.

At a time when the market is focusing on the potential implications of new rules on credit risk weightings for banks globally, US banks continue to excel on the capital front. Over the summer, every US bank passed the latest stress test as well as the subsequent Comprehensive Capital Analysis and Review where capital returns increased nearly across the board and were largely better than expected (click here to see Brennan Hawken's publication). In our view, US banks have demonstrated strengthened capital positions and improved risk management capacities, while offering capital deployment upside potential for investors.

On the domestic regulatory front, we continue to see positive signs as the regulatory environment seems to be no longer deteriorating. Also, capital pressure at European bulge-bracket investment banks could present an opportunity for US banks to gain greater share in their securities businesses. Reflecting our preference for regional banks, our global banks preferred list includes **KEY** (fee revenue cushion) and **Citizens Financial** (an earnings recovery story that can grow earnings with or without higher rates).

Figure 8: Global banks – UBS top picks

	Rating	Market Cap (US$m)	UBS Adj PE 16E	UBS Adj PE 17E	Price / Book 16E	Price / Book 17E	UBS Adj RoE (%) 16E	UBS Adj RoE (%) 17E	Net Div Yield 16E	Net Div Yield 17E
Most preferred										
Bank Rakyat Indonesia	Buy	23,479	12.8x	11.3x	2.2x	1.9x	18.8%	17.8%	2.5%	2.5%
Citizens Financial Group	Buy	13,592	13.9x	12.0x	0.7x	0.6x	4.9%	5.4%	1.8%	2.1%
HDFC Bank	Buy	48,383	21.3x	16.6x	3.8x	3.3x	19.4%	21.2%	0.9%	1.2%
ING	Buy	48,653	9.9x	9.0x	0.9x	0.8x	9.0%	9.6%	6.0%	6.7%
Itau Unibanco	Buy	69,895	10.9x	9.8x	1.9x	1.7x	18.8%	18.6%	3.2%	3.6%
KeyCorp	Buy	10,728	11.6x	10.2x	0.9x	0.9x	7.9%	8.7%	2.6%	2.9%
Lloyds Banking Group	Buy (CBE)	49,466	7.7x	9.2x	0.9x	0.9x	12.3%	10.0%	5.5%	7.3%
Mitsubishi UFJ Financial Group	Buy	69,099	7.1x	7.4x	0.4x	0.4x	6.4%	5.8%	3.6%	3.8%
Sberbank	Buy	53,536	6.4x	5.4x	1.2x	1.0x	20.2%	20.1%	3.1%	3.6%
Westpac Banking Corporation	Buy	76,862	13.2x	13.0x	1.7x	1.7x	14.0%	13.5%	6.2%	6.4%

Source: UBS estimates. Note: Closing prices as at 6 October 2016

Neutral Australia and Japan

Australia: Our neutral stance partly reflects the healthy structure of the Australian banks industry. In the past, much of the NIM pressure has been passed to customers via mortgage re-pricing. However, as has been seen over the past six months, competition has intensified and mortgage re-pricing has been less sticky than in the past. So, it appears as though pressures on margins will continue.

Neutral on Australian banks: Despite ongoing fundamental pressure, attractive dividends underpin defensive qualities

Housing credit growth is coming off its peak (business has also slowed recently) and bad debt charges are normalising, but not running away. However, banks are likely to face further capital raises in 2017 following the announcement of Basel 4 and APRA's interpretation of "unquestionably strong" capital levels.

Near term, we could see some flight to safety in the Australian banks, especially given dividend yields at about 6.1%, while PE valuations are reasonable, given multiples at 12.7x – reasonable levels for the Australian banks. Overall, we continue to prefer the mortgage banks, due to their strong franchises, asset quality and organic capital generation, and include **Westpac** in our global banks preferred list.

Japan: We believe the biggest problem facing Japanese banks today is the super-low interest rate environment, which is exacerbated by the BoJ's negative interest rate policy. Even though the BoJ's recent change in its policy framework to yield curve control could contribute a more stable yield curve, we still see downside risk to net interest income. Rising USD Libor is also a negative factor for major banks' net interest income.

Neutral on Japan: Focus on negative interest rates

We assume earnings decline in FY16 for many major banks, but we think the market has not fully discounted the earnings downside risk. On the other hand, we believe there are no major downside risks to their shareholders' returns and their dividend yield-based valuations are becoming more attractive.

We include **MUFG** in our global banks preferred list, given its better capital position and higher shareholder return level, including share buybacks. Other than shareholder return, given the current tough environment for revenue growth, we think cost reduction should play a big role for earning growth. A reduction in branch networks could be one of the big themes going forward.

Figure 9: GEM banks – UBS top picks

	Rating	Market Cap (US$m)	UBS Adj PE 16E	UBS Adj PE 17E	Price / Book 16E	Price / Book 17E	UBS Adj RoE (%) 16E	UBS Adj RoE (%) 17E	Net Div Yield 16E	Net Div Yield 17E
Most preferred										
Banco Davivienda	Buy	4,429	7.8x	7.2x	1.3x	1.2x	17.7%	17.1%	3.0%	4.4%
Bank Rakyat Indonesia	Buy	23,479	12.8x	11.3x	2.2x	1.9x	18.8%	17.8%	2.5%	2.5%
Banorte	Buy	15,350	15.2x	12.9x	2.0x	1.8x	13.6%	14.5%	1.3%	2.3%
Credicorp	Buy	11,669	11.7x	10.0x	2.0x	1.8x	19.0%	20.1%	2.0%	5.0%
HDFC Bank	Buy	48,383	21.3x	16.6x	3.8x	3.3x	19.4%	21.2%	0.9%	1.2%
Industrial & Commercial Bank of China	Buy	234,938	5.6x	5.5x	0.8x	0.7x	15.2%	14.0%	5.4%	5.5%
Itau Unibanco	Buy	69,895	10.9x	9.8x	1.9x	1.7x	18.8%	18.6%	3.2%	3.6%
OCBC	Buy	26,074	11.0x	11.1x	1.0x	1.0x	9.7%	9.2%	4.4%	4.6%
OTP Bank Nyrt	Neutral	7,244	12.4x	10.2x	1.5x	1.3x	13.4%	14.5%	2.7%	3.2%
Sberbank	Buy	53,536	6.4x	5.4x	1.2x	1.0x	20.2%	20.1%	3.1%	3.6%

Source: UBS estimates. Note: Closing prices as at 6 October 2016

Figure 10: Global banks – least preferred stocks

	Rating	Market Cap (US$m)	UBS Adj PE 16E	UBS Adj PE 17E	Price / Book 16E	Price / Book 17E	UBS Adj RoE (%) 16E	UBS Adj RoE (%) 17E	Net Div Yield 16E	Net Div Yield 17E
Least preferred										
Bancolombia	Sell	9,149	10.8x	10.4x	1.4x	1.3x	13.2%	13.2%	3.0%	2.8%
Commerzbank	Neutral	7,984	9.9x	8.1x	0.2x	0.2x	2.5%	3.0%	1.7%	1.7%
Deutsche Bank	Neutral	18,507	+ve	6.8x	0.3x	0.3x	0.1%	3.9%	0.0%	3.2%
Handelsbanken	Sell	26,719	14.1x	14.6x	1.8x	1.7x	12.6%	11.9%	4.2%	4.8%
Komercni Banka	Neutral	6,777	13.3x	14.7x	1.6x	1.6x	12.2%	10.8%	4.5%	4.1%
National Australia Bank	Neutral	56,432	11.8x	12.0x	1.6x	1.5x	13.1%	13.4%	7.0%	6.4%
Standard Chartered	Sell	27,107	36.3x	19.1x	0.6x	0.6x	1.7%	3.2%	0.0%	2.4%
Wells Fargo & Company	Sell	228,091	11.3x	11.3x	1.2x	1.2x	11.5%	10.8%	3.4%	3.5%
YES Bank	Sell	8,018	20.2x	18.8x	3.4x	3.0x	18.0%	16.8%	0.9%	0.9%
Zions Bancorporation	Sell	6,498	16.5x	14.4x	0.9x	0.9x	5.7%	6.2%	0.9%	1.1%

Source: UBS estimates. Note: Closing prices as at 6 October 2016

Figure 11: GEM banks – least preferred stocks

	Rating	Market Cap (US$m)	UBS Adj PE 16E	UBS Adj PE 17E	Price / Book 16E	Price / Book 17E	UBS Adj RoE (%) 16E	UBS Adj RoE (%) 17E	Net Div Yield 16E	Net Div Yield 17E
Least preferred										
BBVA Banco Frances SA	Sell	3,687	11.9x	12.2x	3.4x	2.8x	30.8%	28.4%	1.7%	2.0%
Bancolombia	Sell	9,149	10.8x	10.4x	1.4x	1.3x	13.2%	13.2%	3.0%	2.8%
Industrial Bank of Korea	Neutral	6,877	6.5x	7.2x	0.4x	0.4x	6.9%	5.7%	4.0%	4.2%
Komercni Banka	Neutral	6,777	13.3x	14.7x	1.6x	1.6x	12.2%	10.8%	4.5%	4.1%
Standard Bank Group Ltd	Sell	16,881	9.9x	9.1x	1.5x	1.4x	15.8%	16.4%	5.1%	5.6%
United Overseas Bank	Neutral	22,225	10.8x	11.0x	1.0x	1.0x	9.7%	9.2%	4.2%	4.5%
VTB	Sell	14,601	54.8x	15.0x	0.6x	0.6x	1.1%	4.1%	2.5%	3.1%
Vakifbank	Sell	3,806	5.4x	5.0x	0.6x	0.5x	12.0%	11.5%	0.7%	0.7%
Woori Bank	Sell	6,931	7.2x	8.9x	0.5x	0.4x	6.6%	5.1%	2.6%	2.6%
YES Bank	Sell	8,018	20.2x	18.8x	3.4x	3.0x	18.0%	16.8%	0.9%	0.9%

Source: UBS estimates. Note: Closing prices as at 6 October 2016

Figure 12: Global banks – valuation summary

	UBS Adj PE			Price / Book			UBS Adj RoE (%)			Net Div Yield (%)		
	16E	17E	18E	16E	17E	18E	16E	17E	18E	16E	17E	18E
Australia	13.3x	12.7x	12.5x	1.7x	1.6x	1.5x	13.5	13.6	13.3	6.1	6.0	6.1
Asia (ex-Japan)	7.5x	7.4x	6.8x	0.9x	0.9x	0.8x	13.9	13.3	13.3	4.0	4.1	4.5
EMEA	8.9x	7.6x	6.5x	1.0x	0.9x	0.8x	14.2	14.5	14.9	3.7	4.2	6.0
Latin America	10.9x	9.8x	8.7x	1.8x	1.6x	1.4x	17.6	17.5	17.6	3.0	3.5	3.9
Japan	7.6x	8.1x	7.8x	0.5x	0.5x	0.4x	6.9	6.2	6.1	3.8	3.9	3.9
United Kingdom	11.8x	11.3x	10.1x	0.8x	0.8x	0.8x	7.1	7.2	8.0	4.9	5.5	5.8
Europe	11.1x	10.1x	8.9x	0.7x	0.7x	0.7x	7.5	8.0	8.6	4.9	5.4	6.0
United States	12.0x	10.9x	9.5x	0.9x	0.9x	0.8x	8.5	8.7	9.3	2.3	2.7	3.0
GEM	8.1x	7.7x	7.0x	1.0x	0.9x	0.9x	14.5	14.1	14.2	3.8	4.1	4.6
GEM (ex-China)	11.3x	10.2x	8.9x	1.3x	1.2x	1.1x	14.6	14.8	15.3	2.9	3.2	3.9
Global Banks	9.9x	9.3x	8.4x	0.9x	0.8x	0.8x	10.7	10.7	11.0	3.8	4.2	4.6

Source: UBS estimates Note: Closing prices as at 6 October 2016

Survey findings

Sentiment remains skewed slightly positive

Our survey found that sentiment towards the sector has remained almost unchanged since our last survey and remains skewed slightly towards being positive. In our last survey, there had been a notable deterioration in sentiment in DM post the UK Referendum. Since then, the Federal Reserve has been reducing rate hike expectations, the Japanese central bank has announced more unorthodox policy measures to try to invigorate inflation and growth (by modifying its policy rate to target a steeper yield curve, aiming for a 0% yield on its 10-year sovereign bond), while in Europe, the market expects QE in the Eurozone to continue. Sterling continues to be weaker than prior the Referendum vote, but we perceive an improvement in EM, as US rates are expected to be lower for longer.

While the percentage of respondents with a positive view on the sector outlook climbed slightly to 35% (33% a quarter earlier), this only slightly exceeds the percentage of respondents with a cautious view (33%). The positive skew is driven by the 5% of respondents holding a very bullish stance, while no respondents currently hold a very cautious view. Figure 2 shows there has been a very slight decline in both the percentage of those with a slightly cautious view and those with a slightly bullish view.

EM outlook is now neutral

After three years of negative sentiment, we now have a neutral stance on EM banks

For emerging market banks, the outlook is now neutral overall and remains polarised, as the proportion of neutral respondents has remained low at 28% (29% previously). The proportion of respondents with a negative view has improved to 36% from 38% in the previous survey, while the number of respondents having a positive view on the outlook has improved somewhat to 36% (previously 33%), with 8% of respondents continuing to have a very bullish outlook.

Upgrading Brazilian banks to overweight

In EM, there have been a few upgrades in the view on the outlook, notably for Brazilian banks, given expectations of a turnaround in macro indications (GDP growth, inflation and policy rates), progress on economic reforms with the focus on a cap on government spending, and early signs of improvements in asset quality: recent meetings with bank management suggest NPL will peak by YE16 with loan-loss provisions in 2H16 lower than in 1H16 (see Why we are warming up on Brazilian banks?).

Very bullish in Hungary

We are also more constructive on Hungary where we are now very bullish after previously being slightly bullish, due to a solid macroeconomic environment, a restarting credit cycle and low CoR, given strong deleveraging. Furthermore, we are now slightly bullish on Kazakhstan where Halyk has been generating high-teen RoEs and we expect improving NIMs.

More cautious on Czech Republic; now neutral in Mexico

In contrast, we have become more cautious on banks in the Czech Republic where we are now slightly cautious (weak fee income and rising provisions). We would also highlight Mexico, which we have downgraded one notch to neutral – the first time that we have been neutral on Mexico since March 2012. Our less constructive view on Mexican banks is primarily driven by external factors, such as Peso weakness and our expectation for valuations, as we approach the US elections on 8 November, while we believe banking fundamentals remain sound.

Overall, we are slightly cautious on banks in the Arab Emirates, Argentina, China, Czech Republic, Korea, Malaysia, South Africa, Thailand and Turkey. We are slightly bullish on Brazil, Georgia, India, Indonesia, Kazakhstan, Peru and Philippines, and very bullish on Hungary and Russia. There are no countries that we rate as very cautious.

Developed market outlook – remaining positively skewed

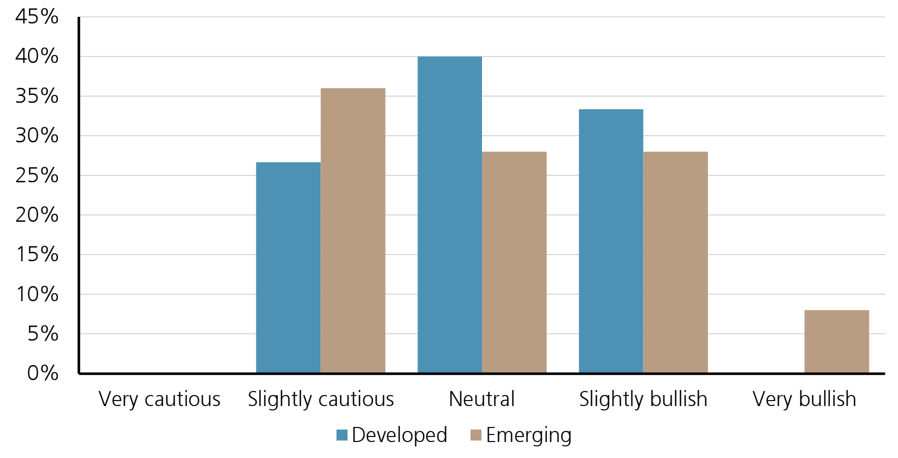
Outlook for developed market banks remains skewed slightly positive

In developed markets, sentiment is in aggregate unchanged from our previous survey, remaining skewed slightly positive. The proportion of respondents with a negative view remains at 27% (unchanged from the previous survey), while respondents with a positive outlook have also remained at 33%. As in our previous survey, there are no respondents with a very bullish view.

Countries showing notable negative changes in sentiment include Germany where we are now slightly cautious (after litigation pressure and capital pressure on Deutsche Bank). We have also further downgraded the outlook for UK banks (lower rates/flatter yield curves) and Japan where the central bank recently announced its intention to target steepening the yield curve to try and prevent deflation.

By country, we are slightly cautious on Australia, Austria, Germany and Spain, while we are slightly bullish on Benelux, France, Italy, Nordic and the US (regionals).

Figure 13: What best describes your view on the outlook for your sector?



Source: UBS

National upgrades/downgrades

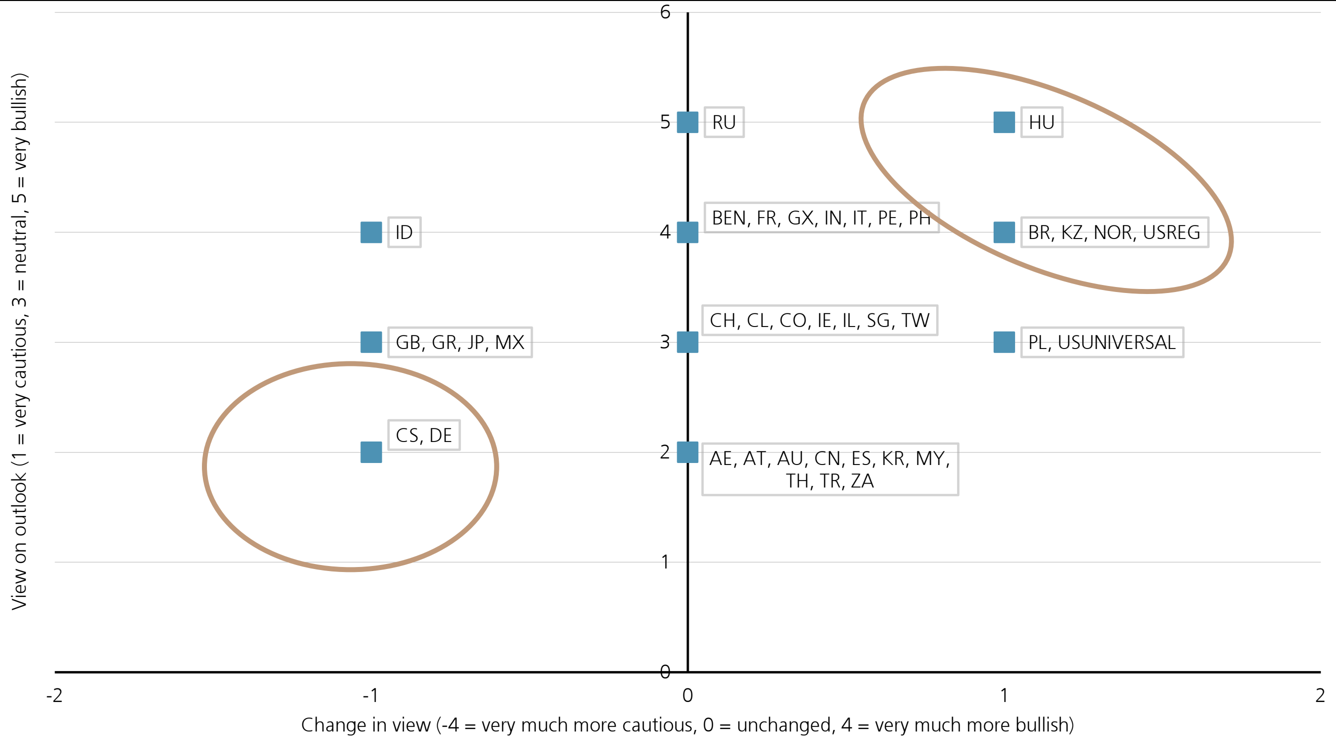
There have been seven downgrades in outlook and seven country upgrades in this latest survey, making for no overall change, with many fewer downgrades or upgrades than in the previous survey (12 downgrades and eight upgrades).

We are slightly more cautious on the Czech Republic and Germany, while we are slightly more bullish on Hungary where we are now very bullish.

We have seen one-notch downgrades also taking place for other countries: the UK, Greece, Japan and Mexico, where we are now neutral, and Indonesia, where we are now slightly bullish.

Similar one-notch upgrades have also taken place for other countries: we are now slightly bullish in Brazil, Kazakhstan, the Nordic countries and US regional banks, and neutral in Poland, and for the US brokers and universal banks.

Figure 14: Analyst views on outlook by country (y axis) and changes in outlook over the past three months (x axis)



Source: UBS analysts. Notes: AE = Arab Emirates, AT = Austria, AU = Australia, BEN = Benelux, BR = Brazil, CH = Switzerland, CL = Chile, CN = China, CO = Colombia, CS = Czech Republic, DE = Germany, ES = Spain, FR = France, GB = United Kingdom, GR = Greece, GX = Georgia, HU = Hungary, ID = Indonesia, IE = Ireland, IL = Israel, IN = India, IT = Italy, JP = Japan, KR = Korea, KZ = Kazakhstan, MX = Mexico, MY = Malaysia, NOR = Nordic, PE = Peru, PH = Philippines (note there was no prior value for this region), PL = Poland, RU = Russia, SG = Singapore, TH = Thailand, TR = Turkey, TW = Taiwan, USREG = United States (regionals), USUNIVERSAL = United States (brokers and universal banks), and ZA = South Africa

Macro views

Bad debt concerns dominate, driven by EM banks

Overall, in this survey, bad debts are the dominant risk factor, being cited by 30% of respondents. In emerging markets, bad debts remain by far the most significant risk for banks, cited by 40% of respondents, although this risk has declined somewhat from the last survey (46% previously). EM countries where this was cited as the primary risk included the Arab Emirates, Brazil, China, Greece, India, Indonesia, Korea, Malaysia, Singapore and Thailand.

In developed markets, this risk factor is seen as low (ranking third), cited by 13% of respondents, and is now considered the primary risk factor only in Italy and Spain.

Macroeconomic growth

Macro outlook remains one of the major risks that UBS analysts see for the banking sector

Overall, in this survey, the macroeconomic growth outlook has become the second of the dominant risks that respondents see for their sector, having been cited by 25% of respondents in the survey. The UK Referendum vote has created growth uncertainties in the UK and Europe, and impacted asset yields and monetary policy expectations with rate cuts in the UK, hikes pushed out in the US and quantitative easing continuing in the Eurozone. This factor was cited by 25% of respondents overall, a decline compared with 33% in the previous survey, and remains an important risk factor in both developed and emerging markets.

In developed markets, the macroeconomic growth outlook is the joint primary risk factor, having been cited by 33% of respondents, versus 47% previously. It is considered the most important risk factor by our analysts in Germany, Switzerland, the UK, US (brokers and universal banks) and US (regionals).

For emerging markets, the macroeconomic growth outlook is the second most important concern, being cited by 20% of respondents (down from 25%), including those in Argentina, Colombia, Hungary, Peru and South Africa.

Regulatory and policy issues

There has been an aggregate decrease in the relative importance of regulatory and policy issues, which are cited by 18% of respondents (previously 10%). It now ranks fourth among the factors cited as being the primary risks to the sector.

In developed markets, this concern ranked as the joint primary risk along with the macroeconomic growth outlook, being cited by 33% of respondents (previously 20%). It was cited as the primary concern for Australia, Benelux, France, Israel and Japan.

In emerging markets, regulatory and policy issues are considered much less important, and were cited by only 8% of respondents: Czech Republic and Poland.

Emerging market currency depreciation

Despite the continued market focus during the survey period on the Fed funds rate and the more dovish stance of the Fed, the importance of currency depreciation has remained almost unchanged as a risk factor in emerging markets. In our latest

survey, it was cited by 12% of respondents (in Georgia, Kazakhstan and Russia), having been cited by 13% of respondents in the previous survey.

Inflation and interest rates

In both developed and emerging markets, this risk has declined in importance over time, albeit that it increased slightly in this survey. It is now ranks as the fourth most important risk, with 10% of respondents (previously 5%) citing this as the most important risk to their sector: Austria, Chile, Taiwan and Turkey.

Political risk

As in our previous survey, political risk is cited by 5% of the survey respondents. In emerging markets, none of our respondents cited it as a risk. The countries where it is considered a risk are Ireland and Mexico.

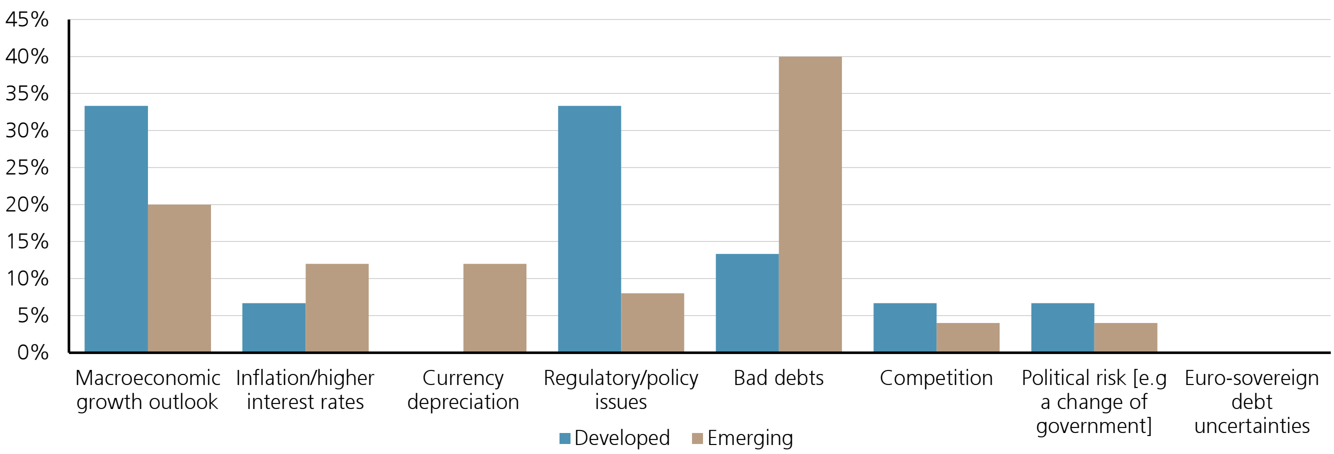
Competition

In previous surveys, competition was not seen as a major risk factor, but it has now resurged as a factor, and is now cited as the major risk factor for Nordic and Philippines banks.

Euro-area sovereign debt uncertainties

As in our previous survey, none of our respondents cited euro-area sovereign debt uncertainties as a risk factor.

Figure 15: What is the main risk to your sector?

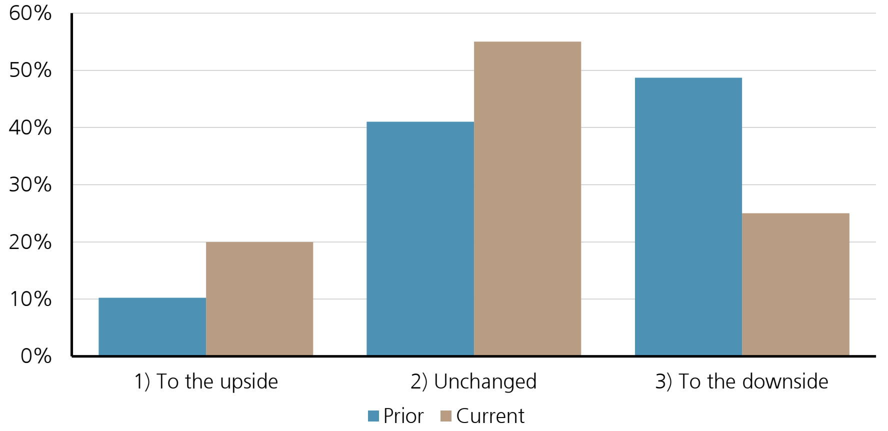


Source: UBS estimates

Views on fundamentals

Loan growth expectations

Figure 16: What is the risk to your loan growth forecast (12-month outlook) – prior versus current?



Source: UBS

Loan growth expectations have improved, but remain skewed to the downside

The overall picture for loan growth has improved considerably compared with the previous survey, but remains skewed to the downside. In this survey, 20% of respondents (previously 10%) believe there is upside risk to loan growth forecasts, while 25% (a significant decline from the previous 49%) believe there is downside risk. The proportion of respondents believing that loan growth forecast risk is neutral has increased to 48% (previously 41%).

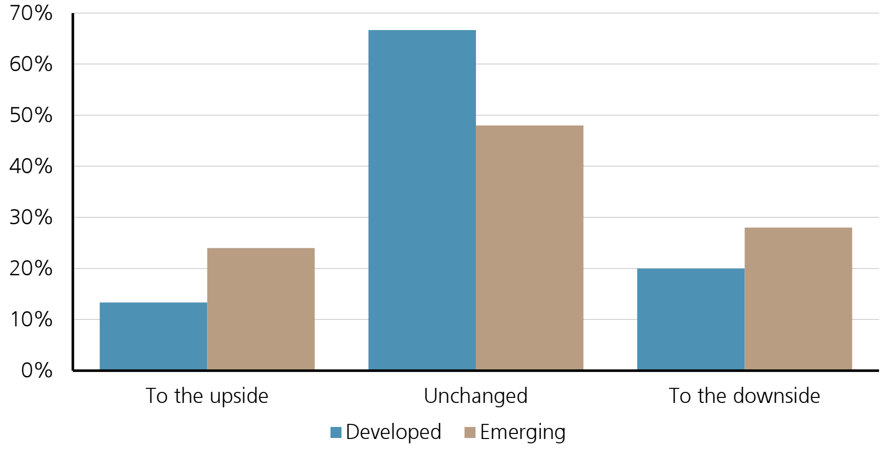
Sharp reduction in the downside risk to loan growth in developed markets

Looking in more detail, it is apparent in developed markets (DM) that there has been a sharp reduction in the proportion of respondents seeing downside risk to loan growth (20% compared with 73% previously), along with a considerable increase in the respondents seeing upside risk (to 13% from 0% previously), but the outlook remains skewed to the downside. Our DM respondents see downside risk to loan growth forecasts in Australia, Switzerland and US regionals, and see upside risk in Austria and Spain.

Downside risk to loan growth remains in emerging markets

In emerging markets (EM), there has been a small improvement in the proportion of respondents seeing upside risk to loan growth (24% compared with 17% previously), while the percentage of respondents seeing downside risk has declined to 28% (versus 33% previously). Despite this improvement, as with the DM banks, the outlook remains skewed to the downside. Our EM respondents see upside risk to loan growth in Argentina, China, Colombia, Hungary, Peru and the Philippines, and downside risk in Georgia, Indonesia, Malaysia, Singapore, South Africa, Thailand and Turkey.

Figure 17: What is the risk to your loan growth forecast (12-month outlook)?



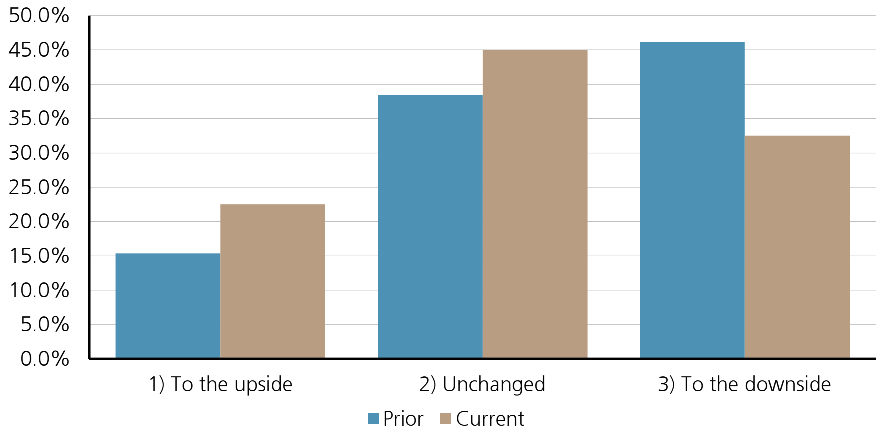
Source: UBS

NIM outlook

Outlook for NIMs remains negative but is improving

The NIM outlook for the next 12 months remains skewed to the downside, but has improved since our previous survey. Some 23% of respondents in our latest survey see upside risk to NIMs, versus 33% seeing downside risk. This compares with a more negative outlook in the previous survey, when 15% of respondents saw upside potential and 46% of respondents saw downside risk. There has been an increase from 38% to 45% in the proportion of respondents who have a neutral/unchanged view of the outlook for NIMs, compared to the previous survey.

Figure 18: What is the risk to your NIM forecast (12-month outlook)?



Source: UBS

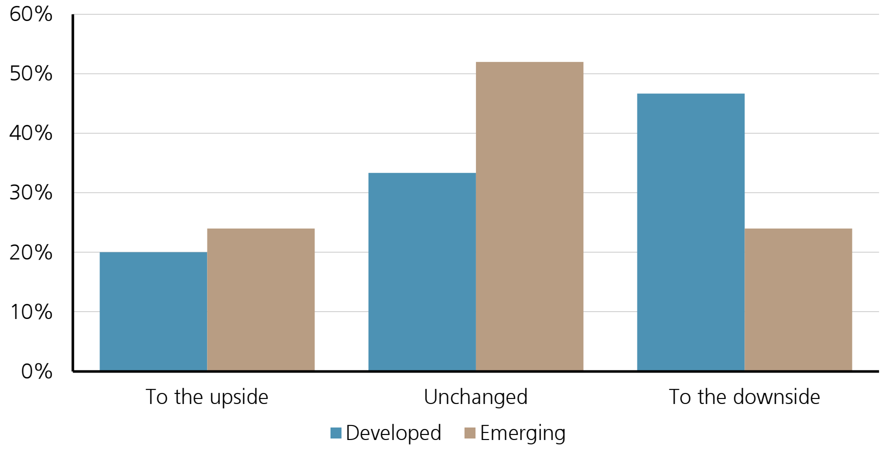
The outlook is less negative, but remains skewed to the downside – driven by DM expectations

In the previous survey, the NIM outlook was very negative for both emerging and developed markets. The outlook is now less negative, but remains skewed to the downside.

In emerging markets, the outlook is balanced: 24% of respondents see downside risk to NIMs (compared with 38% in the previous survey), while 24% see upside risk (versus 21% previously). EM respondents see downside risk in Argentina, Chile, the Czech Republic, India, Malaysia and Thailand, and see upside risk in China, Colombia, Kazakhstan, Mexico, the Philippines and Singapore.

For developed markets, the view has improved, but remains skewed to the downside, with 20% of respondents seeing upside risk to NIMs (7% previously) and a significant improvement of 47% of respondents (previously 60%) seeing downside risk to NIMs, while the proportion seeing unchanged risk to NIMs has remained unchanged at 33%. Our DM respondents see upside risk to NIMs in Israel, US brokers & universal banks and US regionals, and downside risk in Australia, Germany, Ireland, Italy, Japan, Spain and Switzerland.

Figure 19: What is the risk to our NIM forecast (12-month outlook)?



Source: UBS

Policy rates

Policy rates remain by far the most important factor likely to affect NIMs over the next 12 months

In light of market expectations of more policy interventions via quantitative easing, policy rate cuts, and/or delays to policy rate hikes, we are not surprised to see that policy rates are considered by far the most important factor likely to affect NIMs over the next 12 months. Indeed, 55% (previously 64%) of respondents in aggregate cite this as the most important factor likely to affect NIMs over the next 12 months.

In emerging markets, 56% of participants (from 58% previously) cited this as the primary factor; they comprised Argentina, Brazil, Chile, Colombia, the Czech Republic, Hungary, Indonesia, Kazakhstan, Korea, Mexico, Singapore, South Africa, Taiwan and Thailand.

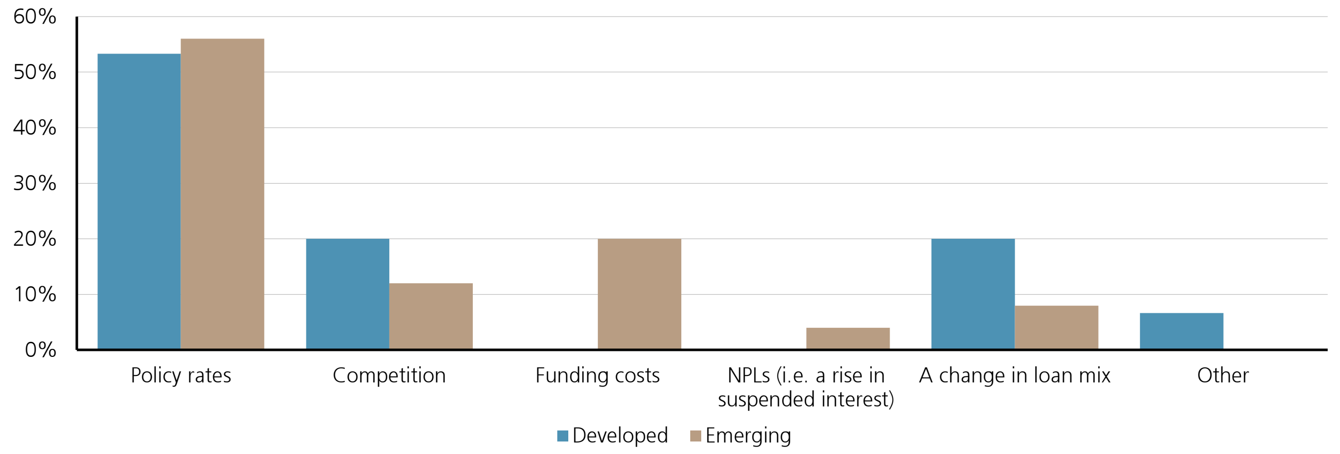
In developed markets, a highly significant 53% of respondents cited policy rates as the primary factor likely to affect NIMs (above the 73% previously). Countries where this factor was cited include Benelux, Germany, Japan, Nordic, Switzerland, the UK, US brokers & universal banks, and US regionals.

The second most important factor likely to affect NIMs for EM banks remains funding costs, cited by 20% (vs 33% previously) of EM respondents (in the UAE, Greece, Malaysia, Russia and Turkey). As in our previous survey, this factor was not cited by any DM respondent.

In DM, the joint second most important factor likely to affect margins was a change in loan mix, and was cited for Austria, Israel and Spain; in EM, this factor was cited for Peru and Poland.

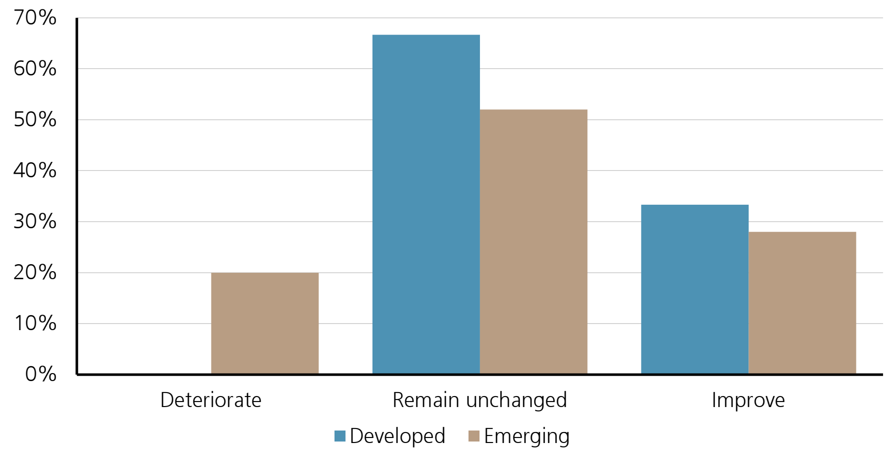
For DM banks, the other second-ranked factor driving NIMs was loan mix, which was cited for Australia, France and Italy. In EM, China, Georgia and the Philippines were cited.

Figure 20: What is most likely to affect net interest margins over the next 12 months?



Source: UBS

Figure 21: Do you expect the funding outlook for your banks over the next 12 months to…



Source: UBS

The funding outlook is now more positive in developed markets than in emerging markets

Compared with our last survey, the overall funding outlook has improved considerably, driven by an improved funding outlook in developed markets, partly offset by a decline in EM. The funding outlook is now skewed to the upside, with 30% of respondents expecting the funding outlook to improve relative to 23% previously, while 13% expect the funding outlook to deteriorate (unchanged).

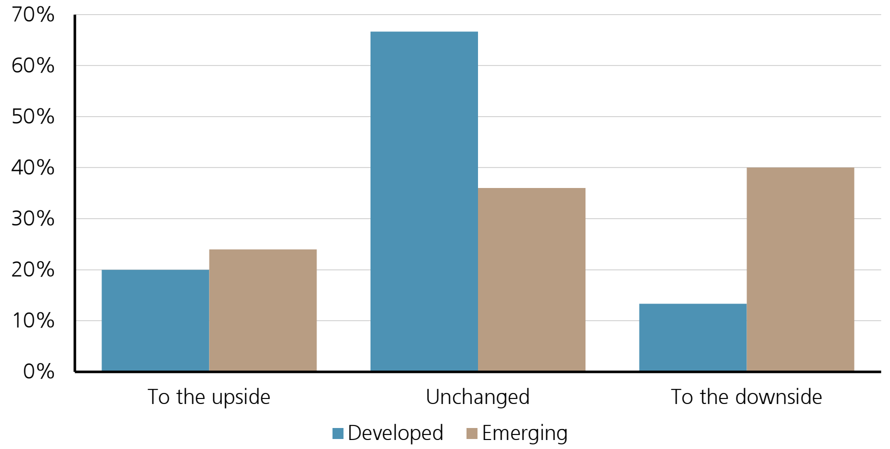
In emerging markets, the outlook on funding has declined but remains skewed to the upside, with those expecting an improvement comprising Argentina, Greece, India, Indonesia, Kazakhstan, Peru and Russia (28% of respondents compared with 29% previously), but the number of respondents expecting a deterioration has expanded considerably. That said, survey respondents are expecting a deterioration only in the UAE, Korea, Malaysia, South Africa and Turkey (20% of respondents compared with 8% previously).

In developed markets, the funding outlook has improved and is now strongly skewed to the upside, with no respondents seeing a deterioration compared with 20% previously. Our respondents see an improvement in the funding outlook in Australia, Ireland, Italy, Spain and the UK (33% of the respondents compared with 13% previously).

Improvement in the funding outlook for developed markets

Asset quality

Figure 22: Is the risk to your NPL forecast over the next 12 months (downside / upside risk to current forecasts):



Source: UBS

In our survey, expectations on the outlook for NPL levels have improved, and are now skewed positively, with 23% (compared with 38% in the previous quarter) seeing a risk to of NPLs being higher than currently forecast, versus 30% seeing downside risk (33% previously), while the proportion of respondents seeing unchanged NPL forecasts has increased significantly from 28% in the previous survey to 48%.

The outlook for NPL levels has improved

Emerging market respondents are now positive on their view of the outlook on NPL levels, with 40% of the respondents seeing downside risk to NPL forecast (42% previously) and only 24% (29% previously) seeing upside risk. Downside risk to NPLs was seen in Brazil, Chile, Colombia, Hungary, India, Kazakhstan, Mexico, Peru, Poland and Thailand, while upside risk was seen in the Arab Emirates, Korea, Malaysia, Singapore, South Africa and Turkey.

The outlook for NPLs in EM is now balanced

In developed markets, the aggregate picture has improved but remains negative, with 20% (vs 53% previously) of respondents seeing upside risk to NPL forecasts and 13% (previously 20%) seeing downside risk. In this survey, respondents see upside risk to NPL forecasts in Australia, Spain and US regionals, and downside risk in Austria and Ireland.

Since our last analyst survey, 2016E NPL/loan expectations have improved slightly compared with the previous period, with 19 countries showing an improvement in forecast NPL levels against 17 countries where analysts forecast a deterioration in NPLs/loans. The largest increases (i.e. deteriorations) in forecast NPL/loan expectations were in Argentina (+83bp to 3.15%), Kazakhstan (+50bp to 10.50%), Indonesia (+33bp to 2.33%), Taiwan (+10bp to 0.49%) and Peru (+10bp to 2.65%).

Conversely, the largest improvements in 2016 forecast asset quality were in Austria (-96bp to 6.66%), Brazil (-93bp to 4.20%), Greece (-60bp to 36.96%), Chile (-30bp to 2.30%) and the Czech Republic (-22bp to 4.01%).

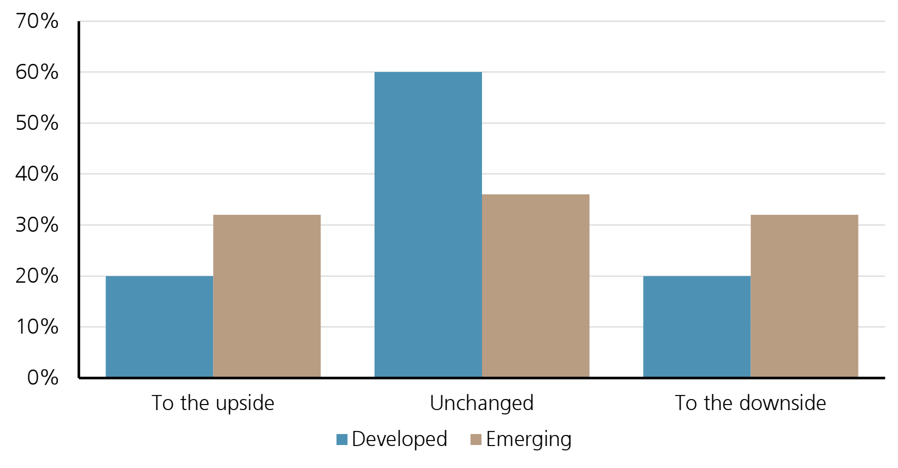
Figure 23: Provisions/average loans

	Provisions / average loans (bp)																			
	00	01	02	03	04	05	06	07	08	09	10	11	12	13	14	15E	16E	17E	18E	19E
Australia	31	41	31	28	24	20	18	24	61	72	40	29	33	25	17	17	23	25	26	27
Japan	59	110	45	120	162	47	23	34	120	65	31	14	15	-5	5	13	8	11	12	12
United States	23	46	290	211	159	130	92	154	315	399	259	121	80	40	38	49	59	68	72	76
Europe	51	80	79	85	61	51	55	58	110	166	105	97	97	87	74	61	56	52	49	47
United Kingdom	50	91	70	107	78	87	101	129	202	269	142	113	81	65	40	45	45	47	43	35
Developed	49	76	143	119	91	69	63	82	158	214	139	87	73	54	49	47	48	51	52	53
GEM	227	272	195	168	119	131	160	138	195	216	164	155	150	130	140	144	179	177	174	173
Global Banks	67	97	148	124	94	79	84	97	170	215	148	112	102	78	77	78	94	95	95	95

Source: UBS estimates

Earnings outlook

Figure 24: What is the risk to your earnings forecast (12-month outlook)?



Source: UBS

Over the past year, reflecting the low growth outlook, 2016E earnings momentum for banks globally remains negative in terms of growth (EPS downgraded by 18.4%), and is significantly negative in terms of the number of downgrades.

2016E earnings momentum for banks globally has been negative in growth terms

Based on our global banks coverage, the net number of 2016E EPS upgrades versus downgrades over the past year is -123 globally; many of the net downgrades have come in Asia (43), with another 29 in Europe, 17 in the US, eight in LatAm and six in Australia. Overall, in GEM, we have 66 net downgrades (66% of our coverage), with the aggregate EPS downgrade being 16.1%.

In the US, we have downgraded our 2016E EPS expectations by 17.0% in the past 12 months and in Europe (ex-UK) by 30.3%.

From our survey, our analysts are now balanced on the risks to earnings forecasts in aggregate for the next 12 months, with 28% seeing upside risk to earnings forecasts and 28% seeing downside risk. Overall, this is a significant improvement compared with the previous survey, where 23% of respondents saw upside risk to earnings and 33% saw downside risk.

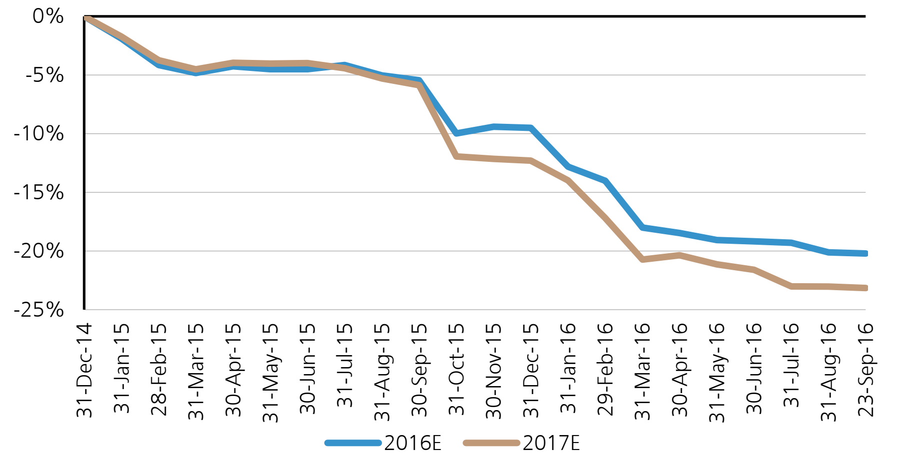
In developed markets, the earnings outlook has improved and is now balanced: although the majority (60%) of respondents see the outlook as unchanged, 20% see upside risk (previously none). The proportion of respondents seeing downside risk to earnings declined to 20% from 47% in the previous survey. The downside risk to earnings is seen in Australia, Germany and Japan, and upside risk is seen in Austria, Spain and US brokers & universal banks.

Earnings outlook for developed markets banks is now balanced

The outlook on earnings in emerging markets has declined and is now balanced: 32% of respondents see upside risk to earnings compared with 38% in the previous survey, while 32% of respondents see downside risk to earnings, which is worse than the 25% of respondents in the previous survey. The emerging markets seeing upside risk comprise China, Colombia, Georgia, Hungary, Kazakhstan, Mexico, Peru and Russia, while downside risk is seen in the UAE, Argentina, the Czech Republic, Malaysia, Singapore, South Africa, Taiwan and Thailand.

Earnings outlook for EM has declined and is now balanced

Figure 25: Global banks – cumulative EPS changes since end-2014

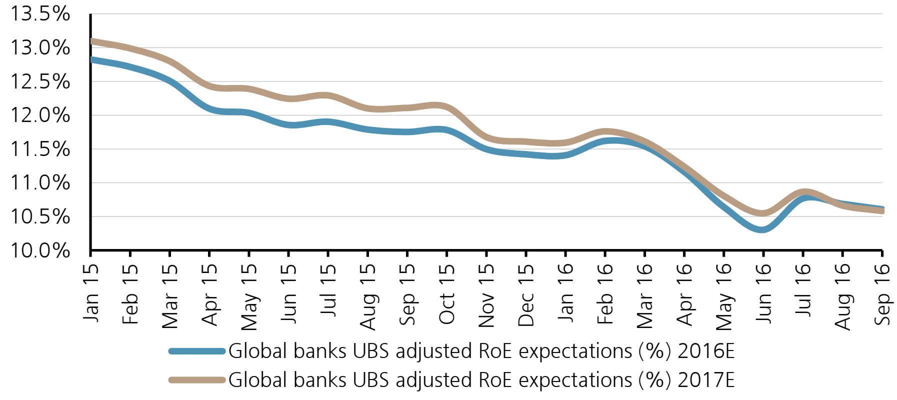


Source: UBS estimates

In our prior survey publications, we reported that RoE expectations had been showing a decline for some time. Since then, the decline in forecast RoEs has continued. The 2016E RoE trend appears to have peaked in early February at 11.8%, declining through the year to 10.3% in June. In July we had a temporary reprieve in that trend with a short-term bounce-back, but RoEs have since declined to 10.6%. The 2017E RoE trend seems to be fairly closely tracking the 2016 estimates, and the spread between the two appears to be closing, suggesting that 2017 is unlikely to be a better year than 2016 from the perspective of RoEs.

Expectations for global banks' RoE remain on a downward trend

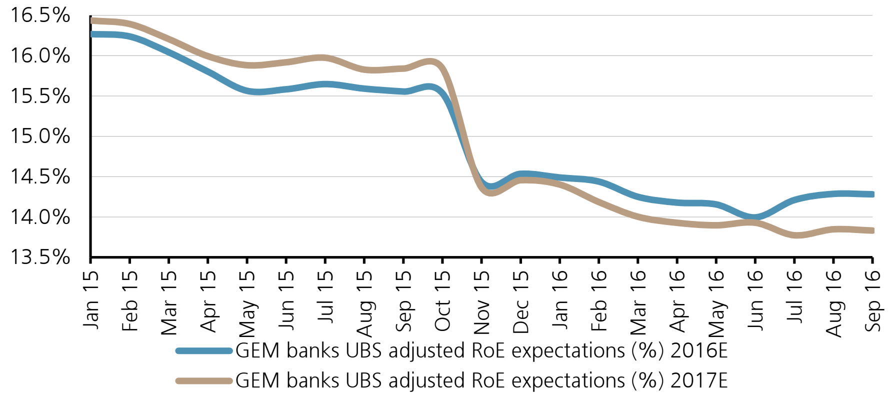
Figure 26: Global banks – RoE expectations



Source: UBS estimates

Based on our bottom-up estimates, we currently forecast 2016 sector RoE for global banks to be 10.9% – below the 2014 value of 11.3%, which was among the lowest figures since 2000, apart from 2008 (7.8%) and 2009 (10.0%). The outlook is for RoE to remain low at 10.8% in 2017E, only recovering to 11.1% in 2018E and 11.4% in 2019E.

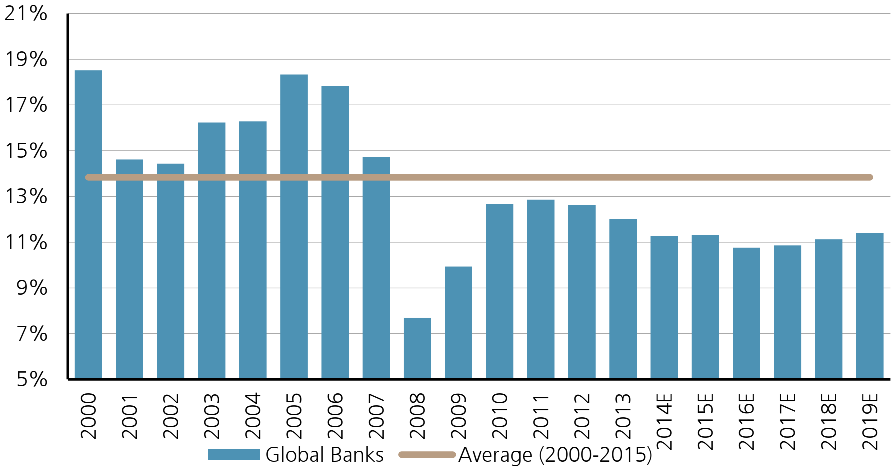
Figure 27: GEM banks – RoE expectations



Source: UBS estimates

In emerging markets, 2016 RoE expectations have fallen sharply since the plateau in third-quarter 2015 to a trough in June 2016, but have slightly rebounded since. For 2016, RoE estimates are now 14.3% – about 128bp lower than a year ago. Estimates for 2017 have followed a similar trajectory, although the gap between the two estimates has widened since June 2016: at 13.8%, our 2017 estimates are 45bp below our 2016 estimates.

Figure 28: Global banks – RoE trends



Source: UBS estimates

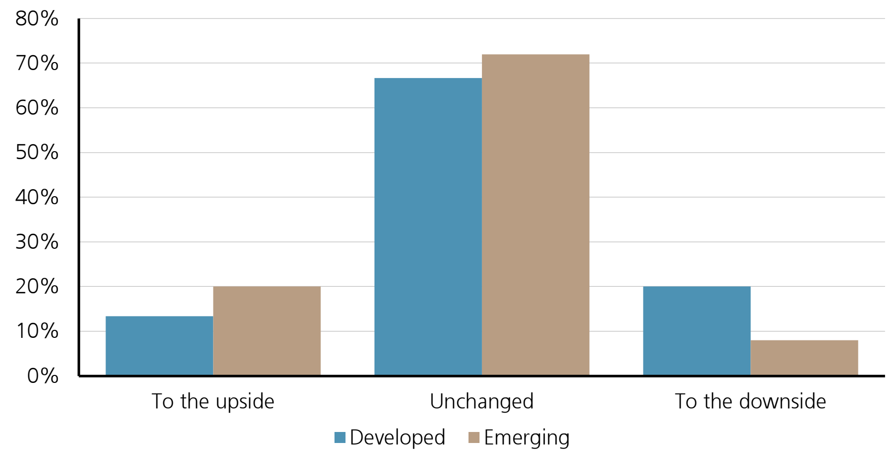
Dividend outlook

UBS analysts now have a positive view of dividend risk

UBS analysts overall have become more positive than in our previous survey, and now have an overall positive view regarding the risk to dividends, with only 13% seeing downside risk (from 36% in our previous survey). The proportion of respondents seeing upside risk has increased to 18% from 15% in the previous survey.

In developed markets, there has been improvement in the outlook for dividends compared with the previous survey, although our survey respondents still have a negative view on the outlook for dividends: 20% of respondents (previously 47%) see downside risk and 13% see upside risk (previously 13%). Developed-markets analysts seeing upside risk to dividends include those covering Spain and US regionals, while those seeing downside risk cover Australia, Israel and Italy.

Figure 29: What is the risk to your dividend estimates for your sector over the next 12 months?



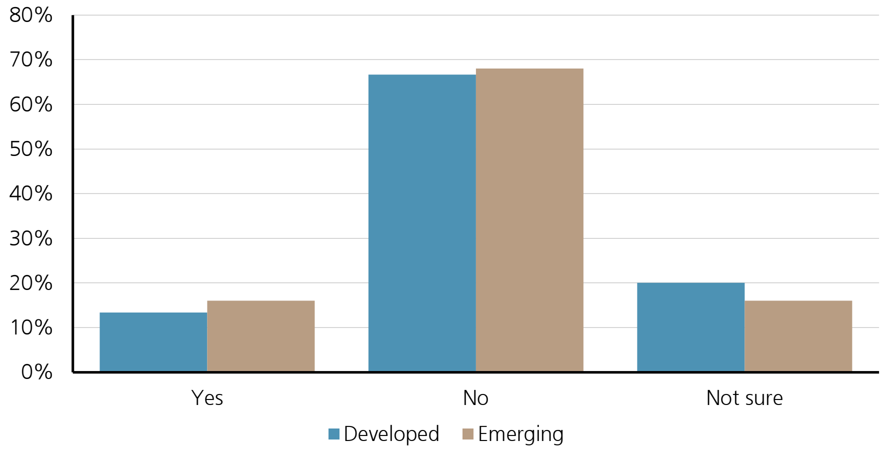
Source: UBS

In emerging markets, the dividend outlook has improved and is now skewed to the upside, with 20% of respondents (previously 17%) seeing upside risk and 8% (previously 29%) seeing downside risk. Upside risk to dividends is seen in

Argentina, Indonesia, Kazakhstan, Mexico and Peru, while downside risk is seen in the Czech Republic and Poland.

Recap risks

Figure 30: Will your bank have to raise capital over the next 12 months?



Source: UBS

Capital-raising fears persist in some regions

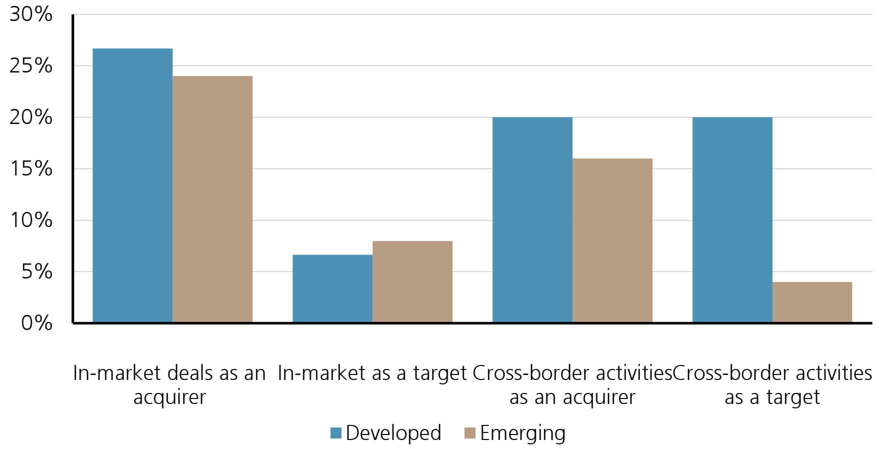
Since our last survey, the perceived capital position of the banks has remained almost unchanged, with the vast majority of respondents (68% vs 74% previously) believing that the banks they cover will not need to raise capital over the next 12 months. In the latest survey, 15% of respondents see capital raises over the next 12 months, versus 13% in the previous survey, while the proportion of "not sure" responses has risen to 18% compared with 13% previously.

In emerging markets, 16% of respondents expect to see capital raises over the next 12 months, a little higher than in our previous survey, when 13% of respondents expected to see capital raises. EM countries where we expect capital raises include Argentina, China, Colombia and India.

The proportion of DM respondents expecting capital raises over the next 12 months remains unchanged at 13%. Even though there was a round of capital raises in Australia last year, Australia and Austria are the only DM countries where our respondents believe capital raises might happen in the next 12 months.

M&A

Figure 31: Do you expect your banks to be involved in any M&A activity over the next 12 months?



Source: UBS

In-market M&A acquisitions expected in Italy, Spain, Switzerland and US regionals

Some 27% of developed-market respondents see the banks they cover being involved in in-market activity as an acquirer over the next 12 months, (previously 33%), and 20% undertaking cross-border M&A as an acquirer (previously 27%). In-market M&A acquisitions are expected in Italy, Spain, Switzerland and US regionals, while cross-border acquisitions are expected from banks based in Austria, Japan and Switzerland.

For M&A activity where the respondents see their banks as M&A targets, 20% see cross-border activity (Austria, Israel and US regionals), compared with 20% in the previous survey, while 7% (previously 27%) expect in-market activity (US regionals).

There is a significant expectation of M&A activity in emerging markets, both in-market and cross-border. The majority of this activity is expected to involve the researched banks acting as an acquirer: 24% in-market (25% previously) and 16% cross-border (13% previously). In-market M&A acquisitions are expected in Argentina, Brazil, Georgia, India, Korea and Poland, while cross-border acquisitions are expected from banks based in Brazil, Hungary, Singapore and South Africa.

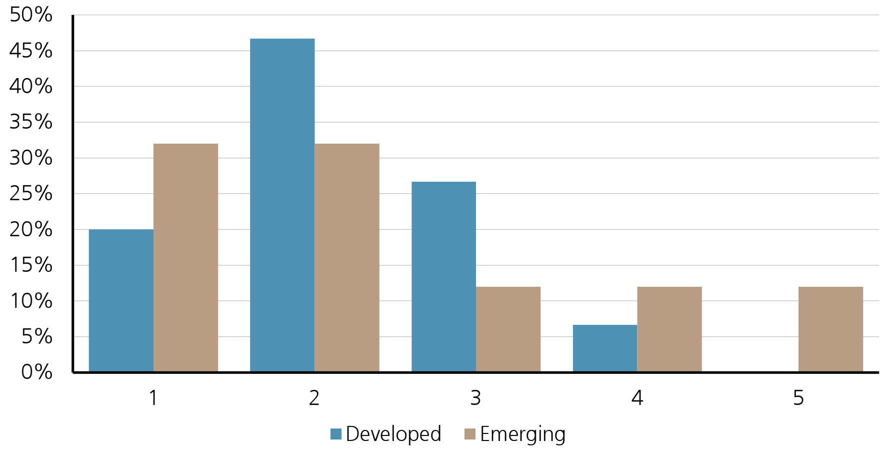
There are lower expectations of M&A where our researched emerging-market banks are expected to be the target. For in-market M&A, this is expected for only 8% of markets (India and Poland), and for cross-border M&A, 4% of markets (Russia).

FX volatility

FX volatility largely viewed as having a low to medium impact on fundamentals

Given continued FX volatility, especially in emerging markets, our latest survey also included a question on the potential impact of currency movements on bank sector fundamentals. According to our survey findings, FX volatility was largely considered to have a low to medium impact on fundamentals (predominantly via translation effects), but also in terms of the impact on loan growth and potentially higher delinquencies via higher policy rates. In emerging markets, the banking sectors that were considered most vulnerable to FX volatility included Georgia, Indonesia and Kazakhstan, while in developed markets no countries were considered to fall into that category.

Figure 32: On a scale of 1-5 (where 1 = minimal effect and 5 = severe effect), how does FX volatility affect sector fundamentals?

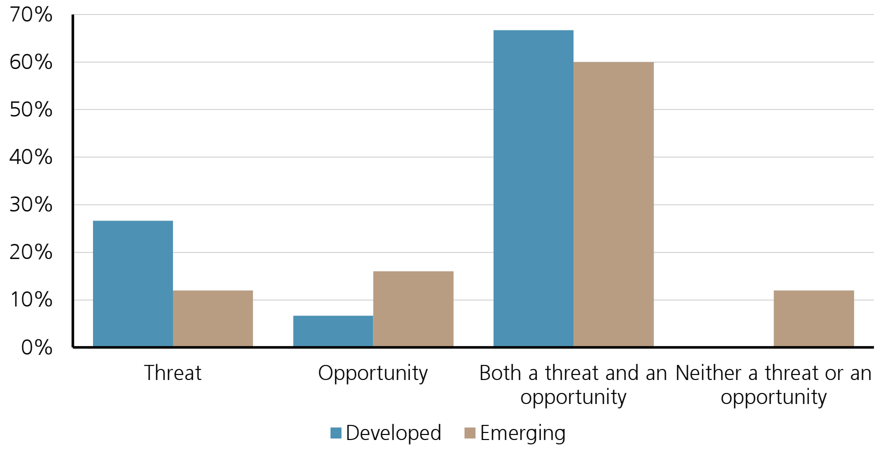


Source: UBS estimates

FinTech

In our Global banks outlook for 2016, we identified financial technology (FinTech) as a key theme for the year ahead. We followed up on this theme in our recent Q-Series: Global Banks – Is Fintech A Threat or An Opportunity?. In this survey, we again asked our analysts how they viewed FinTech – as a threat and/or opportunity.

Figure 33: How do you view FinTech?



Source: UBS estimates

The majority of our analysts are positive on the opportunities FinTech may present

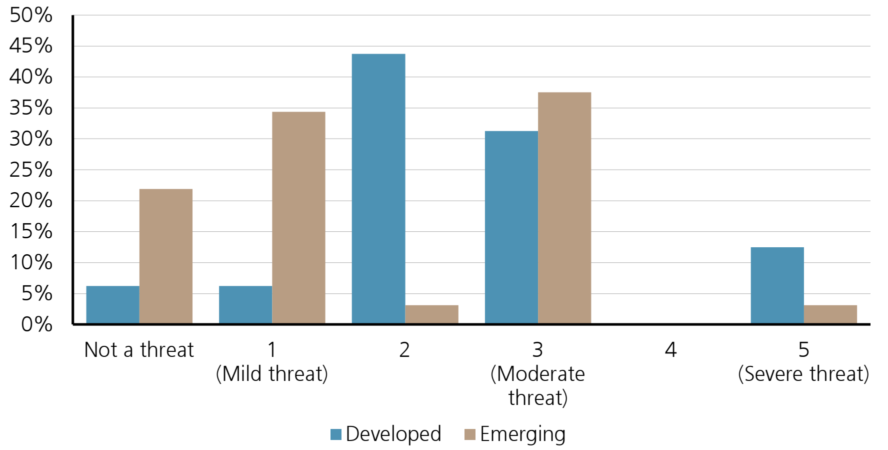
The survey shows that the majority of our analysts are still positive on the opportunities that FinTech may present: 75% of our respondents believe that FinTech presents an opportunity or presents both a threat and an opportunity, up from 62% in our previous survey. Our EM analysts are somewhat less positive than our DM analysts: 66% of EM respondents see opportunities from FinTech, versus 73% of DM respondents.

Looking at the other side of the coin, we found that 80% of respondents overall see FinTech as a threat or both a threat and an opportunity (previously 72%). Mirroring the EM/DM split on FinTech as an opportunity, our EM analysts were relatively more positive when viewing FinTech as a threat: 72% of EM analysts see

FinTech either as a threat or both a threat and an opportunity while 93% of DM analysts chose these two options.

When looking at the extent of the threat, it is apparent that DM respondents were much more concerned than EM respondents. When asked to rank the level of threat between one and five (with 5 being most severe), 13% of DM respondents considered the threat level to be between 4 and 5, while only 3% of EM respondents put the threat level in the same brackets.

Figure 34: How do you rate the threat of FinTech to your banks?



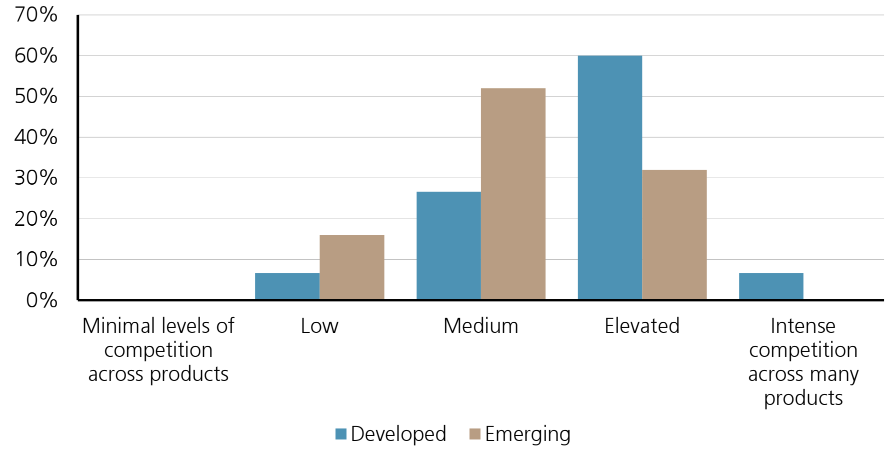
Source: UBS estimates

Competition

In this survey, we also asked our analysts for their view on the competitive landscape for their banks over the next 12 months. Compared with our last survey, both DM and EM analysts are expecting more intense competition. It is also clear from the results that our DM analysts believe that competition is more intense in some markets than do their EM peers, with 67% (previously 73%) of DM respondents selecting the Elevated or Intense categories, and only 32% of EM respondents selecting the same categories (44% previously). However, the proportion of EM respondents believing their markets are likely to experience medium levels of competition is higher (52%) than the proportion of DM respondents (27%). In DM, countries where competition was considered most intense were Germany (Intense competition) and Australia, Austria, France, Israel, Italy, Japan, Spain, US brokers & universal banks, and US regionals (Elevated). In EM there were no countries in the Elevated bracket, but our respondents considered that the Czech Republic, Georgia, India, the Philippines, Poland, Russia, South Africa and Turkey had elevated levels of competition.

Compared with our last survey, both DM and EM analysts are expecting more intense competition

Figure 35: Overall, what is the outlook for competition for your banks over the next 12 months?



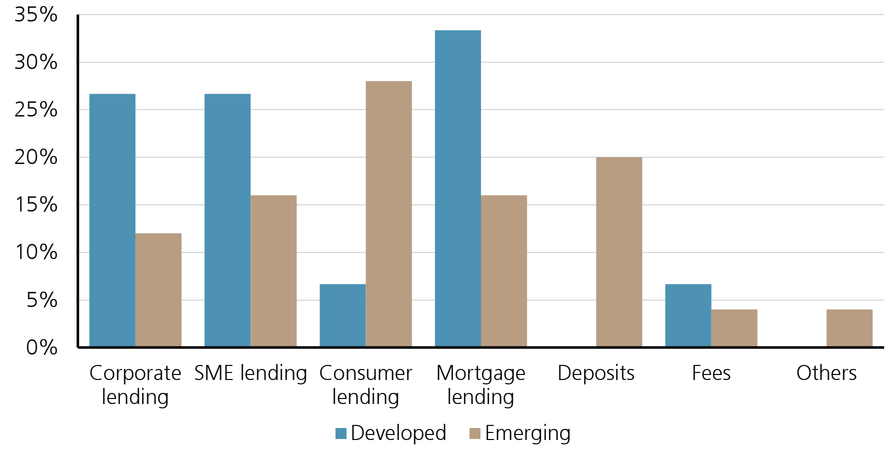
Source: UBS estimates

Competition likely to be highest in mortgage lending, followed by the consumer and SME lending segments

By product, competition was expected to be toughest in the mortgage lending segment (23% of respondents), followed by the consumer lending (20%) and SME lending (20%) segments.

A breakdown between banks in DM and EM showed that, in DM, competition was seen as likely to be toughest in the mortgage lending segment (33%), followed by the corporate lending and SME lending segments (both 27%), and lowest for deposits (0%). In contrast, in EM, competition was considered likely to be highest for consumer lending (28%) and then deposits (20%), and least intense in fees (4%).

Figure 36: Overall, which product line do you think will see the most competition?

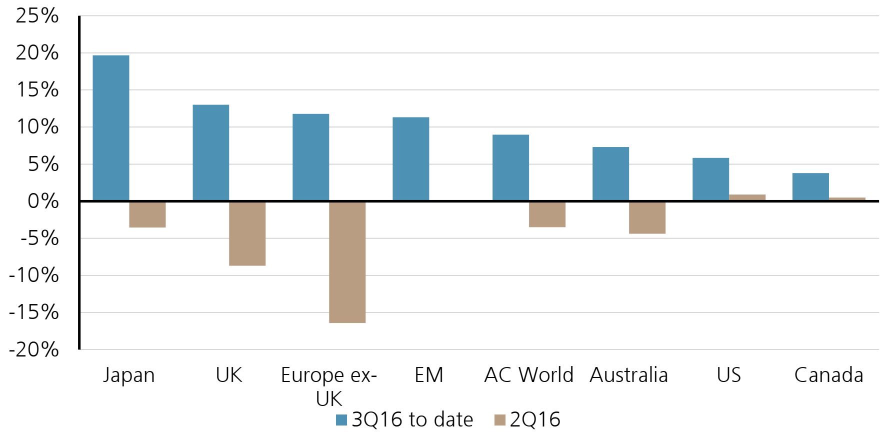


Source: UBS estimates

Views on valuations

Significant underperformance year to date

Figure 37: Global banks' US$ performance, 3Q16 versus 2Q16



Source: MSCI indices, Thomson Reuters DataStream, UBS. Note: Based on closing prices as at 27 September 2016.

Global banks have outperformed equities by 8.3% since the start of 2016

The global banks' sector performance has been highly volatile and has staged a significant rally in Q3. Since the start of 2016, the global banking index is down 4.2% (in US dollars) but the sector has out-performed global equities by 8.3%. In 2015, global banks were down 11.8%, underperforming global equities by 7.9%.

By region, DM banks have clearly underperformed their EM peers. Since the start of 2016, DM banks are down 8.4% versus EM banks up 17.0%. Among DM banks, Canadian banks have held up best, gaining 17.0% year to date. In contrast, the European ex-UK banks have been the most disappointing, falling 18.9% this year, closely followed by the UK banks (-18.4%). The US banks have also performed poorly, with sector year-to-date performance of -7.3%.

With limited spill-over risk from the UK EU referendum vote, more dovish Fed comments and a recovery in EM currencies, the sector performance of emerging market banks has been surprisingly resilient with share prices up 17.0% since the start of the year after a fall of 24.1% in 2015.

Fair value or cheap?

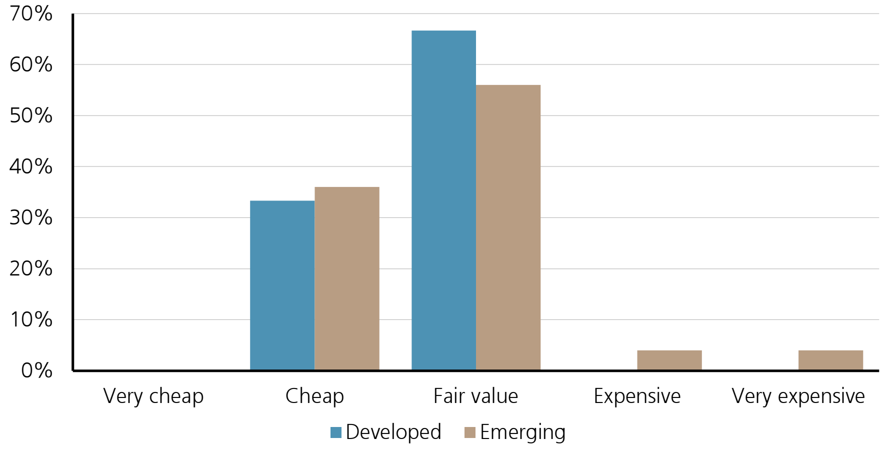
The sector is largely considered by UBS analysts to be between fair value and cheap

Given the share price underperformance of global banks over the past year (negative earnings momentum and the threat of increased legislation), a large number of our respondents consider the banks they cover to be cheap/very cheap (35% of respondents, down from 59% previously, reflecting the rally in Q3). At the same time, 60% of the respondents consider the banks they cover to be fairly valued (up considerably from 33% previously). Only 6% of respondents believe the sector is expensive or very expensive, compared with 8% in the previous survey.

Our analysts' view on valuations in developed markets has become less emphatic: currently, 33% of respondents believe their sector is cheap (0% very cheap), while in the previous survey, 67% of analysts believed their sector was cheap and 0% very cheap. In the current survey, none of the DM respondents believed their sector was expensive (unchanged from the previous survey) while 67% of respondents believe their sector is at fair value.

In emerging markets, the aggregate view remains skewed to the cheap side, though less emphatically so. In the current survey, 36% of respondents believe the sector is cheap or very cheap, compared with 54% in our previous survey. The proportion of respondents believing their sector is expensive or very expensive has declined to 8% (12% previously). The proportion of analysts believing their sector is at fair value has increased significantly to 56% from 33% previously.

Figure 38: Sector valuations – do you consider your sector to be:



Source: UBS

The “expensive” category comprises the Czech Republic (very expensive) and Argentina. The "cheap" category comprises Austria, Benelux, China, Greece, Hungary, Indonesia, Italy, Japan, Kazakhstan, Peru, Russia, Singapore, Turkey and US regionals).

Valuation Method and Risk Statement

Sector forecasts and ratings are subject to developments in the wider economy and the macro environment. Stock prices could be negatively affected by rapid changes in interest rates or a slower-than-expected rebound in the economy, which, among other things, could result in higher loan losses and/or slower loan growth than is currently anticipated.

Required Disclosures

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UBS Investment Research: Global Equity Rating Definitions

12-Month Rating	Definition	Coverage[1]	IB Services[2]
Buy	FSR is > 6% above the MRA.	47%	32%
Neutral	FSR is between -6% and 6% of the MRA.	38%	25%
Sell	FSR is > 6% below the MRA.	15%	21%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 30 June 2016.
1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category.
4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

KEY DEFINITIONS: Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months. **Market Return Assumption (MRA)** is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium). **Under Review (UR)** Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation. **Short-Term Ratings** reflect the expected near-term (up to three months) performance of the stock and do not reflect any change in the fundamental view or investment case. **Equity Price Targets** have an investment horizon of 12 months.

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Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Banco Davivienda[6b, 6c, 7]	DVI_p.CN	Buy	N/A	P28,980.00	06 Oct 2016
Bancolombia[6b, 6c, 7, 16b]	CIB.N	Sell	N/A	US$38.05	06 Oct 2016
Bank Rakyat Indonesia[7]	BBRI.JK	Buy	N/A	Rp11,975	07 Oct 2016
Banorte[2, 4, 5b, 7]	GFNORTEO.MX	Buy	N/A	P106.35	06 Oct 2016
BBVA Banco Frances SA[5b, 16b]	BFR.N	Sell	N/A	US$20.60	06 Oct 2016
Citizens Financial Group[4, 6a, 6b, 7, 16b]	CFG.N	Buy	N/A	US$25.69	06 Oct 2016
Commerzbank[2, 4, 5b, 7, 14]	CBKG.DE	Neutral	N/A	€5.69	07 Oct 2016
Credicorp[7, 16b]	BAP.N	Buy	N/A	US$146.30	06 Oct 2016
Deutsche Bank[2, 4, 5b, 7, 16b]	DBKGn.DE	Neutral	N/A	€12.09	07 Oct 2016
Handelsbanken[4, 7]	SHBa.ST	Sell	N/A	SKr119.40	07 Oct 2016
HDFC Bank[6b, 6c, 7, 16b]	HDBK.BO	Buy	N/A	Rs1,281.10	07 Oct 2016
Industrial & Commercial Bank of China[2, 4, 5b, 7, 16a]	1398.HK	Buy	N/A	HK$5.00	07 Oct 2016
Industrial Bank of Korea[7]	024110.KS	Neutral	N/A	Won11,750	07 Oct 2016
ING[2, 4, 6a, 7, 16b]	INGA.AS	Buy	N/A	€11.25	07 Oct 2016
Itau Unibanco[7, 16b]	ITUB4.SA	Buy	N/A	R$37.70	06 Oct 2016
KeyCorp[6b, 6c, 7, 16b]	KEY.N	Buy	N/A	US$12.73	06 Oct 2016
Komercni Banka[7]	BKOM.PR	Neutral	N/A	Kc870.90	07 Oct 2016
Lloyds Banking Group[2, 4, 7, 14, 16b, 20]	LLOY.L	Buy (CBE)	N/A	53p	07 Oct 2016
Mitsubishi UFJ Financial Group[2, 4, 5b, 6a, 7, 16b, 18b]	8306.T	Buy	N/A	¥526.6	07 Oct 2016
National Australia Bank[2, 4, 7, 22]	NAB.AX	Neutral	N/A	A$28.17	07 Oct 2016
OCBC[7]	OCBC.SI	Buy	N/A	S$8.68	07 Oct 2016
OTP Bank Nyrt[7]	OTPB.BU	Neutral	N/A	HUF7,435.00	07 Oct 2016
Sberbank[4, 6b, 6c, 7, 18a]	SBER.MM	Buy	N/A	RBL148.74	07 Oct 2016
Standard Bank Group Ltd[4, 7]	SBKJ.J	Sell	N/A	RCnt14,598	07 Oct 2016
Standard Chartered[2, 4, 5b, 7, 16a]	STAN.L	Sell	N/A	674p	07 Oct 2016

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
United Overseas Bank[2, 4, 5b, 6b, 6c, 7]	UOBH.SI	Neutral	N/A	S$18.80	07 Oct 2016
Vakifbank[5b, 6b, 6c, 7]	VAKBN.IS	Sell	N/A	TRY4.57	07 Oct 2016
VTB[6b, 6c, 7, 18a]	VTBR.MM	Sell	N/A	RBL0.07	07 Oct 2016
Wells Fargo & Company[2, 4, 5b, 6a, 6b, 6c, 7, 16b]	WFC.N	Sell	N/A	US$45.18	06 Oct 2016
Westpac Banking Corporation[2, 4, 5a, 7, 16b, 22]	WBC.AX	Buy	N/A	A$30.57	07 Oct 2016
Woori Bank[6b, 6c, 7, 16b]	000030.KS	Sell	N/A	Won11,350	07 Oct 2016
YES Bank[7]	YESB.BO	Sell	N/A	Rs1,275.10	07 Oct 2016
Zions Bancorporation[4, 6b, 6c, 7, 16b]	ZION.O	Sell	N/A	US$31.68	06 Oct 2016

Source: UBS. All prices as of local market close.
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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