FUND MANAGEMENT DIARY

Meeting held on 6th March 2018

Are the World's Banks back to Normal?

- Domestic lending growth in most advanced economies now looks about "normal" but it still looks too high in China

- New global regulations have resulted in banks around the world now holding more liquid assets, making a bank run less likely, and having more capital, making them better able to absorb losses

- However, serious risks remain in the Italian and Chinese banking systems and a possible reversal of regulatory reforms in the United States could end up sowing the seeds of a new crisis

What would a world with "normal" banks look like?

A world in which banks were back to "normal" might not be a good thing. It might mean under-regulated, over-leveraged, "too-big-to-fail" banks taking excessive risks that put economic and financial stability at serious risk. A more desirable "normal" would be a situation in which banks are likely to contribute positively to economic growth, without causing the preceding problems.

Domestic lending growth has largely recovered

Since the financial crisis, trends in bank lending have differed markedly between advanced and emerging economies. In advanced economies, lending growth fell sharply in 2008, leaving it negative at the end of 2009, and recovered only gradually after that. This lending recovery in advanced economies has been driven by banks in the United States, particularly since 2014, while those in Europe have lagged behind. And in the United Kingdom, after six years of decline, lending only started to recover towards the end of 2015.

Meanwhile, lending surged in emerging economies in late 2007 and early 2008. It eased over the following years in most countries, but still outpaced that in advanced economies. China was an exception to this as a policy-driven surge in lending in 2009 was used to help keep the economy growing quickly. Lending growth then slowed gradually over the following years but was still over ten per cent at the start of this year.

However, cross-border lending by banks in advanced economies has contracted since the financial crisis. Among advanced economies, the contraction has been sharpest in Europe. A lack of data means we do not have a complete picture for the major emerging economies, but the available information shows diverging trends.

For example, between 2008 and 2017, the cross-border loans and deposits of Indian banks rose by almost 60 per cent, albeit from a very low level, while those of Brazilian banks shrank.

Bringing all this together, while cross-border lending is low by past standards, domestic lending growth in most advanced economies looks about “normal”. In China, though, it is still too high.

The quality of bank loans has deteriorated in many countries

In many countries, the quality of bank loans has deteriorated since 2010 – the earliest year for which comparable data are available. Among major advanced or emerging economies, as a proportion of total loans, non-performing loans (those for which interest and/or principal payments are not being made) are by far the highest in Italy (17.1 per cent), followed by Russia (9.4 per cent) and India (9.2 per cent). And there are some high rates of non-performing loans in the euro-zone aside from Italy, such as Portugal, Ireland, Greece and Cyprus. Meanwhile, in China, non-performing loans may look low (1.7 per cent), but we suspect that banks have significantly understated their true level.

The high ratio in Italy partly reflects the economy’s poor performance since joining the euro. And Russia’s high ratio is partly due to the economic downturn since oil prices plummeted in 2014. Indeed, the countries in which the non-performing loan ratio has fallen furthest since 2010 (for example the United States and the United Kingdom) are also those in which gross domestic product has risen the furthest.

That said, economic performance is not the only determinant of non-performing assets. For example, inefficiencies in the Italian legal system mean that it takes longer than elsewhere for banks to seize the collateral backing non-performing loans, or for the debtor to be declared bankrupt. The slower outflow of non-performing loans means that the stock of them builds up more quickly.

But regulatory changes have strengthened balance sheets

Although non-performing loans have risen in many countries, so have banks’ abilities to absorb losses. This is largely due to regulatory changes, notably the Basel III regulations which were introduced by the Financial Stability Board (an organization of the world’s central bankers) in 2013. Among other things, these rules set global minimums for banks’ holdings of liquid assets, as well as the proportion of banks’ activities that are funded by capital rather than debt.

Partly as a result of these new regulations, banks are now less vulnerable to liquidity problems. Indeed, in 2016 banks in both advanced and emerging economies generally held more liquid assets relative to their short-term liabilities than in 2010.

This reduces the risk of default, because if a large number of a bank's creditors attempted to withdraw their funding at the same time, the bank would find it easier to sell liquid assets and repay those creditors.

Banks have also increased their capital since the financial crisis. Admittedly, when looking back to the end of the 19th Century, the ratio of banks' capital to their total assets still looks low. But it has at least risen since 2007. And, on average, banks' capital/asset ratios in advanced economies' are now at their highest level since before the Second World War.

Immediate threats to the banking system in advanced economies look low

The stronger state of banks' balance sheets compared to a few years ago suggests that over the coming years, bank loans should generally be available to customers who want them. And prospects for loan demand also look positive. After all, on the whole in advanced economies, deleveraging among households and firms is nearly over. So with the global economy performing fairly well, both households and firms might be willing to take on extra debt. As long as borrowing doesn't surge, this would help to support economic growth in the medium term.

That said, there are serious risks on the horizon. Among the advanced economies, the warning lights are flashing brightest in Italy. Non-performing loans are high, and the country's economic prospects are far from bright. So banks there will remain vulnerable to losses of confidence, which could make the economic situation even worse and mean that further government support is needed. A major crisis there could also hinder efforts towards banking union in the euro-zone.

Among the emerging economies, China is the biggest concern. The banks have almost certainly not recognised the full extent of their bad loans, and the underlying causes of their problems are unlikely to be resolved soon. While we are not forecasting a crisis, the risks are rising.

More generally, while the threats to the banking system in advanced economies look quite low for the coming few years, this is unlikely to be the case indefinitely. Moves by the United States administration to row back on the regulatory reforms which were introduced after the crisis may end up sowing the seeds of a new crisis. And the unresolved tension between devolved fiscal policy and monetary union could yet come back to haunt the euro-zone.

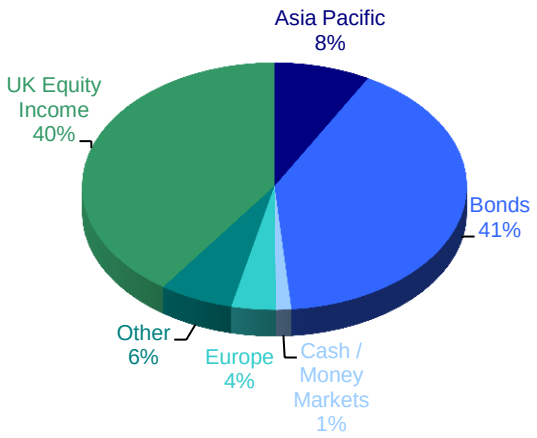
Strategy

This week's article points towards debt being relatively high, especially in emerging economies. Future Money feel that high debt levels alone do not provide a strong leading indicator, and instead, the focus should be on the ability of individuals and

institutions to pay those debts. It should also be noted, in our opinion, that ‘one man’s debt is another man’s asset’ and therefore debts to one institution, are an asset on a balance sheet for another institution. Consequently, asset levels are also high, and given that rates are currently low and we expect central banks to raise rates gradually, we do not feel that overall debt is a concern, as debts can be paid.

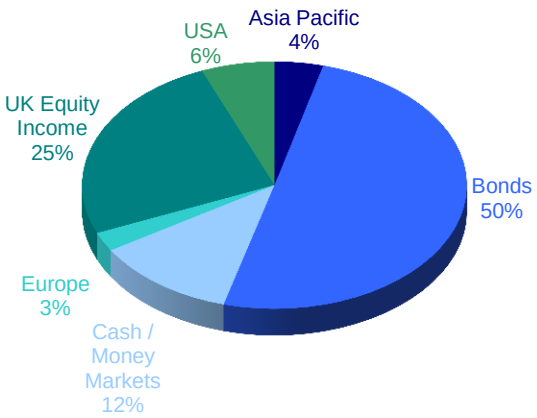
Income

A replacement holding is being considered for the M&G UK Inflation Linked Corporate Bond fund. This fund has delivered good returns relative to conventional short dated bonds as inflation has increased, but its relatively low yield has always been a factor against this fund. Given that UK inflation is on a relative high and the fund has benefitted from this, a replacement with a higher yielding fund is now being planned.



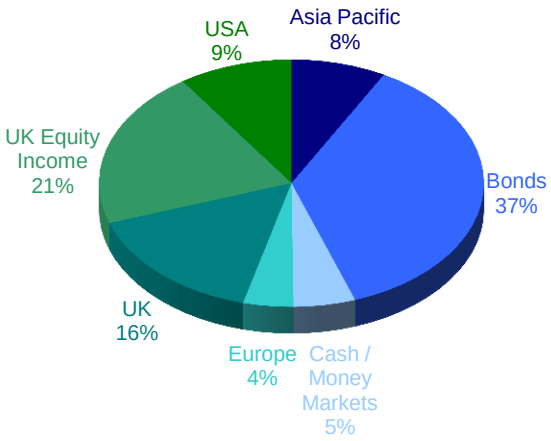
Real Value

The portfolio will continue to hold the M&G UK Inflation Linked Corporate Bond in the short term. Unlike in Future Money Income, the low yield is not a major consideration for Real Value and therefore the diversification offered by this fund's inflation focus remains a compelling characteristic. However, the short dated fixed income space is being monitored for new opportunities.



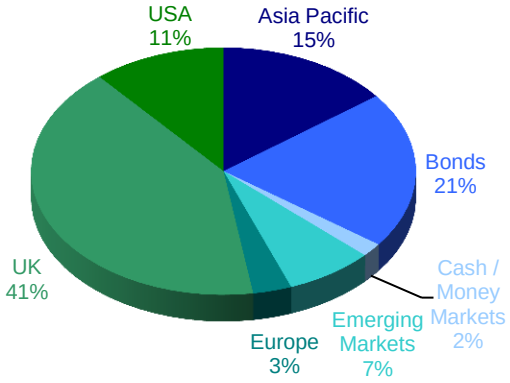
Real Growth

Similar to Real Value, the M&G UK Inflation Linked Bond remains in the portfolio for now, however, replacement options are being considered. Elsewhere, the Rathbone Income fund has been slightly disappointing and will be reviewed.



Dynamic Growth

Further to the comments in last week's diary, the move from Majedie UK Equity to JPM UK Dynamic is taking place this week. No further changes are currently being considered for Dynamic Growth.



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Any research is for information only, does not constitute financial advice or necessarily reflect the views of the author and is subject to change.

It remains the responsibility of the financial adviser to verify the accuracy of the information and assess whether the fund is suitable and appropriate for their customer.

Past performance is not a reliable indicator of future performance. The value of investments and the income derived from them can fall as well as rise and investors may get back less than they invested.

Important information about the funds can be found in the Supplementary Information Document and NURS-KII Document which are available on our website or on request.

For any information about the Future Money funds please contact the authorised corporate director, Margetts Fund Management Ltd, on 0121 236 2380, admin@margetts.com or at 1 Sovereign Court, Graham Street, Birmingham B1 3JR. A copy of their Terms of Business which relates to investments into the funds can also be obtained using these contact details.

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