GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee
February 8, 2024

Once more unto the breach

Atul Bhatia, CFA – Minneapolis

A year on from the collapse of several regional U.S. banks that roiled the industry and Wall Street, a new chill, mounting losses on real estate loans, is sending a shiver down the spine of markets. Despite the hard realities, we think there's also a fair dose of hyperbole going around. We dissect the problem before arguing that the overall U.S. banking system is healthy and able to weather the likely volatility ahead.

The core business of banking is mundane. Deposits are turned into loans, loans generate cash flows, depositors are repaid, and the whole cycle starts up again. The picture is a little more complicated with stock and bond investors included, but not by much.

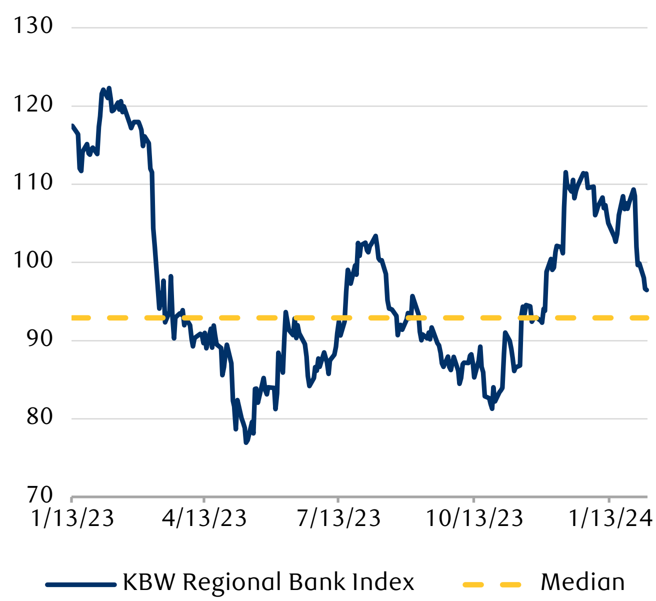
Nothing about this is headline-worthy when done well, so we think it's disconcerting to see small U.S. banks in the news. This round of falling regional bank stock prices comes amid concerns on banks' exposure to commercial real estate (CRE), particularly office and retail properties that have been negatively impacted by changing work and shopping habits.

Problems, yes; catastrophe, no

Unlike most of the doom-and-gloom predictions that pop up from time to time, there is a kernel of truth to the narrative on CRE, in our view. Losses are real, and the impact will be felt. At the same time, we think press reports paint with too broad a brush when discussing the topic. There are huge differences between the events of 2008, for instance, and what we see as the reasonably likely outcomes for banks today.

Bank stocks pull back; remain above recent lows

Despite an 11% drop in seven days, index is above near-term median



Source - RBC Wealth Management, Bloomberg; data through 2/7/24

For perspectives on the week from our regional analysts, please see pages 4–5.

For important disclosures, required non-U.S. analyst disclosures, and authors' contact information, see page 7.

Priced (in USD) as of 2/7/24 market close (unless otherwise stated). Produced: 2/8/24 2:57 pm ET; Disseminated: 2/8/24 3:10 pm ET

At the level of publicly traded banks, we think it is very unlikely that large banks will be stressed, and we are not concerned with the solvency of the overall banking system. Instead, we think we are likely to see stress in some smaller banks, as rising credit losses could force capital raising that would, in turn, pressure security prices. Moreover, we would not be shocked to see larger, well-heeled banks scooping up CRE-troubled lenders at discounted prices.

In short, our view is not exactly "business as usual," but is instead "resolution as usual," with any problems in small banks largely dealt with by the normal capitalist process of resource reallocation.

First, the hard realities

CRE is a meaningful problem. Projects are closing and properties are being sold well below recent appraised levels. Bank lenders, who are typically the first in line for repayment, are almost certainly going to do better than project developers and junior lenders, but "better" is different than "good" and we're expecting noticeable losses in the banking system. According to the National Bureau of Economic Research (NBER), U.S. banks overall hold approximately $2.7 trillion in CRE loans, so this is not an issue that has been manufactured to sell newspapers.

Not only is the size of CRE exposure an issue for banks, but it's also fundamentally different than the financing issues that hit regional lenders last March. After Silicon Valley Bank's (SVB) failure, the need was to fund good assets as depositors left. That's the textbook reason central banks exist, and the Federal Reserve could—and eventually did—provide the necessary loans to calm the waters. Last year, we pushed back on the idea that there was a crisis largely because the solution was obvious to us and easy to implement. Our view was that post-SVB, bank failures were a policy choice, not an economic requirement.

This time around, though, we are not dealing with an easy-to-solve funding mismatch, but a real problem: allocating the losses on loans that have gone bad and where the bank will never recover the full amount of the original loan.

Those losses go first to the capital layer. A well-reserved and capitalized bank in the U.S. will have equity to cover a loss of around 10 percent of its assets—some have more, some have a little less. Even in a recession, that's usually plenty to deal with credit losses, but unexpected stress can quickly make the math look challenging: even if a relatively trivial three percent of assets are tied to the most problematic office loans, for instance, a simple calculation shows that nearly 25 percent of a bank's capital could be at risk in a scenario of widespread defaults and low recoveries.

Any institution facing those kinds of losses would likely be forced to cut dividends and take other measures to shore up its balance sheet and appease regulators. Critically, though, we think a bank in that position should still be solvent—we're discussing deep wounds, not necessarily fatal ones.

The sun will come up tomorrow

Despite the real problems in the sector, there is also a fair dose of hyperbole, in our view.

To begin with, CRE is an incredibly broad label, covering everything from cold storage facilities to apartment buildings. The current set of concerns is focused on three primary loan types: office space, retail, and multifamily housing. But even within this set of assets there is huge variation in the likely outcomes between individual properties. The $2.7 trillion figure from NBER is a theoretical maximum exposure; the practical risk in the banking system, we believe, is a small fraction of that amount.

Importantly, the risks on the largest loans have been distributed through securitizations and other transfer mechanisms. Outside of specialized funds, very few investors that we are aware of have large allocations to the most troubled CRE sectors. We believe this reduces—even if it does not necessarily eliminate—the pressure to sell assets at deeply discounted prices and minimizes the odds of contagion, where losses in one sector lead to forced selling in other markets.

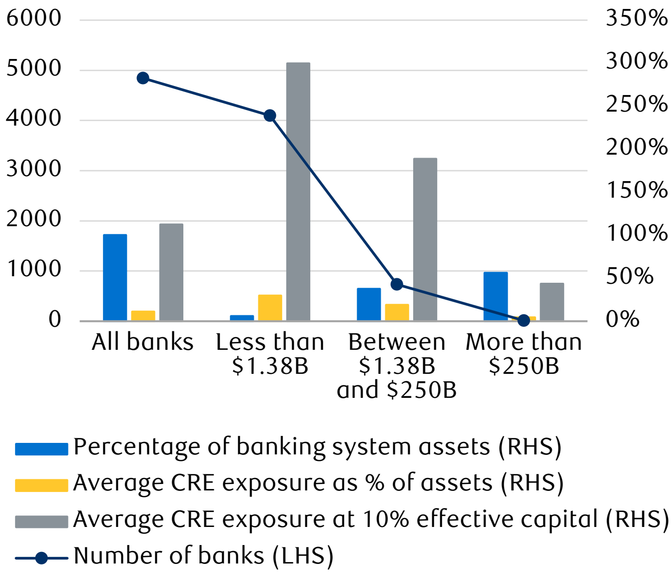
Go big or stay home?

For the banking system overall, we believe there is sufficient capital to absorb a complete write-down of the entire $2.7 trillion in estimated CRE exposure, although that would leave it essentially drained of equity. The issue, of course, is that the allocation of capital does not necessarily match the allocation of likely losses. We believe this problem is particularly acute at small lenders.

To begin with, smaller banks are the major players in the CRE space. According to the NBER, banks with less than $1.4 billion in assets account for about $419 billion of the banking system's exposure; this corresponds to about 25 percent of smaller bank assets by our calculations. In absolute terms, the largest banks—those with over $250 billion in assets—have greater CRE exposure, but it amounts to less than five percent of their overall investments, according to NBER data.

Small banks' reliance on CRE is a double hit. Not only are they seeing large write-downs on existing loans, but pressure from investors also makes it difficult to aggressively originate new loans, reducing earnings and making it more difficult to replenish the coffers. Larger banks, by comparison, have diverse revenue streams

Large number of banks have CRE risk, but large banks have less of it



Source - RBC Wealth Management, National Bureau of Economic Research; data through 12/31/22

and the impact of diminished CRE lending is, on average, barely noticeable.

Depositor and investor concerns about small bank exposure to a troubled asset class also raise the risk of money being pulled from these institutions, much like we saw after the fall of SVB. This time around, however, it will not be as easy for the Fed to swoop in and provide assistance, given the concerns around the ultimate repayment of the loans, a factor that was absent in last year's Treasury bond-focused turmoil. Even banks that continue to find funding may need to pay more for it, adding to financial stress. One bright spot we see for these banks is that after last year's depositor flight, there's reason to believe that remaining depositors are stickier and may stay with the bank despite negative headlines.

A final issue, particularly for the smallest community banks, is loan concentration. Average loan sizes in the CRE world are much larger than in retail banking, so even a few problem loans can have a meaningful impact on the results and capital of a small bank. As an example, New York Community Bank was in the news recently following a nearly ninefold increase in loan loss provisions, driven partly by two CRE credits, as well as increased reserve build for the loan portfolio in aggregate. And that's an institution with over $100 billion in assets; for a smaller community bank, a single bad loan is potentially a meaningful event.

Many paths ahead

Despite the realities and the risks, we think widespread bank failures from CRE exposure remain unlikely. We see small banks coming under pressure on two fronts: rising losses on CRE loans cutting into capital levels, while more expensive funding and reduced lending opportunities serve as a headwind to earnings. This may lead to some bank failures, but we do not foresee anything that would unduly stress existing mechanisms to resolve troubled banks.

We think the largest banks, by contrast, will likely do fine in any CRE pullback, as their lower exposure and cheaper funding allow them to take advantage as opportunities arise. We think the U.S. banking system is healthy and will be able to weather the likely CRE volatility ahead.

UNITED STATES

Kelly Bogdanova – San Francisco

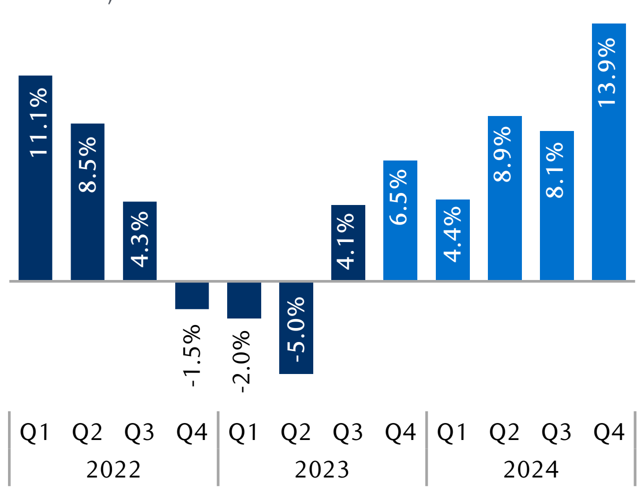
- **The S&P 500 has continued to advance, recording new all-time highs and pushing closer to the 5,000-level milestone.** It has rallied 4.7% year to date as of Wednesday's close despite recent concerns about the regional banking sector's exposure to distressed commercial real estate properties. We think the market's advance is persisting due to optimism about an economic soft landing and potential Fed rate cuts, declining inflation, solid Q4 earnings results, optimism about 2024 earnings, and sheer momentum. Six sectors have posted healthy year-to-date gains: Communication Services (+10.6%), Information Technology (+8.4%), Health Care (+5.8%), Financials (+3.8%), Consumer Staples (+2.7%), and Industrials (+2.4%). Four of the sectors have recently reached new highs—the two tech-related sectors and Health Care and Industrials. Since this rally began in late October, the S&P 500 has risen 21.3%.

- **With 76% of S&P 500 market capitalization having reported results thus far, Q4 2023 earnings growth is pacing at 6.5% y/y,** well ahead of the 1.2% y/y consensus forecast at the start of earnings season, according to Bloomberg. We're more focused on the fact that the 2024 consensus forecast has ticked down only about 2% to $243 per share since last June. Typically within this stretch of time, the full-year consensus forecast drops by more than twice that rate. $243 per share would represent 8.9% y/y growth.

- But when digging into the quarterly growth estimates for 2024, **we can't help but notice that Wall Street analysts are forecasting a back-end loaded year with Q4 earnings expected to rise 13.9% y/y**, as the chart shows. Quite often when growth is this tilted toward year-end, the optimism doesn't pan out and the Q4 estimate ends up getting trimmed as the year progresses. Most management teams have not yet provided detailed quarterly guidance for 2024, and the sector assumptions that are built into the Q4 growth estimate leave us skeptical. It turns out that S&P 500 earnings growth in the first two quarters of 2024 is mainly dependent on double-digit earnings growth from the Communication Services and Information Technology sectors, which seems reasonable to us. But growth in Q4 is dependent on five other sectors also posting double-digit earnings growth. This leaves little wiggle room for economic slowing and seems unrealistic, in our view.

2024 earnings growth forecast is back-end loaded

S&P 500 consensus earnings per share growth year-over-year (dark blue are actual data; light blue are consensus estimates)



Source - RBC Wealth Management, Bloomberg; data as of 2/8/24

CANADA

Estefani Ayazo, CFA & Jonathan Laser, CFA – Toronto

- **The Bank of Canada (BoC) remains concerned about reducing interest rates prematurely amid elevated shelter inflation and robust wage growth**, according to the latest BoC meeting minutes. The deliberations suggest officials are weighing the risk of holding interest rates elevated for too long, which would raise the likelihood of an economic downturn, against the risk of cutting rates too soon and reigniting inflationary pressures. The minutes noted that shelter inflation remains a source of concern, given the possibility that a stronger-than-expected rebound in housing market activity could fuel shelter price pressures. BoC officials recently highlighted the limitations of monetary policy in influencing housing cost increases that are driven by a structural supply shortage and rapid immigration growth. Lastly, policymakers noted that elevated wage growth in an environment of lackluster productivity growth could feed into price pressures. However, the BoC expects wage pressures to ease as labour market conditions gradually soften in the months ahead.

- **The Canadian business activity downturn eased in January** as inflationary pressures softened and firms' economic outlooks improved. The S&P Global Canada Services Purchasing Managers' Index (PMI) ticked up to 45.8 last month from 44.6 previously, remaining below the level of 50 that separates expansion from contraction for the eighth consecutive month. While business activity in the services sector, which accounts for roughly two-thirds of the economy, remains tepid, the overall pace of contraction slowed last month. Meanwhile, the S&P Global Canada Manufacturing PMI rose to 48.3 in January, up from 45.4 in December and marking a three-month high. Production fell for the sixth consecutive month while new orders also dropped, though the declines were less severe compared to December. In our view, the Canadian economy will likely continue to soften as tighter financial conditions weigh on household spending and business investment, but potential rate reductions by the BoC could help provide some relief to the broader economy.

EUROPE

Thomas McGarrity, CFA – London

- **At the headline level, it has been a fairly unimpressive earnings season in Europe so far, with negative surprises outweighing positive ones and the number of earnings beats below average at around 45%.** Notably, though, there have been sharp share price moves for positive surprises, led by large caps including ASML Holding N.V., SAP SE, and LVMH Moët Hennessy Louis Vuitton, three of the seven largest companies in the STOXX Europe ex UK Index. Conversely, companies missing consensus estimates have only underperformed by around 0.1% on average, which is the smallest negative price reaction in four years. In our view, this may indicate investor expectations are not particularly elevated.

- **Europe's largest company by market capitalization, Novo Nordisk, gained over 5% in the week** after announcing it would acquire three "fill-finish" manufacturing sites for $11 billion. The company stated that the sites would increase its capacity to package and seal its GLP-1 medications for diabetes treatment (e.g., Ozempic) and obesity management (e.g., Wegovy) over the medium term.

- **Unilever reported Q4 results broadly in line with consensus expectations, with underlying sales growth of 4.7% y/y**. While growth continued to be led by pricing, up 2.8% y/y, volume growth inflected positively and reached 1.8% y/y, beating the expectation of 1.1% y/y and Q3's -0.6% y/y. The CEO stated: "Today's results show an improving financial performance, with the return to volume growth and margins rebuilding. However, our competitiveness remains disappointing and overall performance needs to improve. We are working to address this by improving our execution to unlock Unilever's full potential."

- **AstraZeneca, the second-largest company in the UK's FTSE 100 Index with a weighting of roughly 7.5%, fell 6% after it reported earnings per share (EPS) below consensus expectations** due to higher-than-expected research and development costs and general expenses. For 2024, AstraZeneca's management forecast total revenue and core EPS to increase by a low-double-digit to low-teens percentage at constant exchange rates.

ASIA PACIFIC

Nicholas Gwee, CFA – Singapore

- **Asia Pacific equity markets traded higher during the week, led by China and Hong Kong**. The Shanghai Shenzhen CSI 300 Index is up more than 5% since hitting a five-year low last Friday, driven by a string of market rescue measures by Beijing.

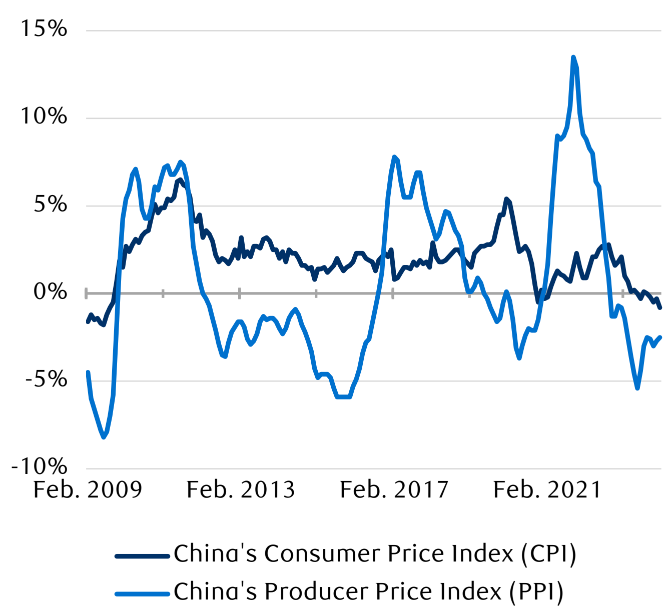
- **Notable new efforts in the past week** include the China Securities Regulatory Commission's (CSRC) promise to guide more medium-to-long-term funds into the market and crack down on malicious short selling and insider trading; adding liquidity of approximately RMB 1 trillion into markets; providing support for home builders; using the sovereign wealth fund to buy more exchange-traded funds and using state funds ("National Team") to buy more onshore Chinese shares; and tightening trading restrictions on domestic institutional investors as well as some offshore units.

- **Beijing surprised the market by replacing CSRC Chairman Yi Huiman with Wu Qing, a close ally of Premier Li Qiang**. We view the move as the latest sign that the government is responding with urgency to stem the stock market's recent results, while market observers believe the move may signal additional measures to revive the world's second-largest stock market.

- **China's Consumer Price Index (CPI) fell 0.8% y/y in January, the steepest decline since 2009 and below economists' -0.5% y/y expectation**. Meanwhile, the Producer Price Index declined for the 16th straight month to -2.5% y/y, although the result was slightly better than the -2.6% y/y consensus projection. As the real estate crisis persists, we think the recent stock market decline adds to investors' and consumers' concerns. Economists broadly expect deflation pressure in China to continue for at least another six months, largely due to the real estate turmoil.

China's CPI saw its biggest drop since 2009; PPI has declined for 16 consecutive months

Year-over-year price change



Source - RBC Wealth Management, Bloomberg; data through 1/31/24

MARKET Scorecard

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,995.06	3.1%	4.7%	20.0%	11.4%
Dow Industrials (DJIA)	38,677.36	1.4%	2.6%	13.2%	10.2%
Nasdaq	15,756.64	3.9%	5.0%	30.1%	12.4%
Russell 2000	1,950.36	0.2%	-3.8%	-1.1%	-3.1%
S&P/TSX Comp	20,969.18	-0.3%	0.1%	1.2%	-1.3%
FTSE All-Share	4,163.67	-0.2%	-1.6%	-3.4%	-1.7%
STOXX Europe 600	485.63	0.0%	1.4%	6.0%	4.4%
EURO STOXX 50	4,678.85	0.7%	3.5%	11.2%	13.5%
Hang Seng	16,081.89	3.9%	-5.7%	-24.5%	-34.6%
Shanghai Comp	2,829.70	1.5%	-4.9%	-12.9%	-17.5%
Nikkei 225	36,119.92	-0.5%	7.9%	30.5%	32.6%
India Sensex	72,152.00	0.6%	-0.1%	19.7%	25.2%
Singapore Straits Times	3,156.15	0.1%	-2.6%	-6.6%	-6.2%
Brazil Ibovespa	129,949.90	1.7%	-3.2%	20.5%	16.0%
Mexican Bolsa IPC	58,658.71	2.2%	2.2%	10.0%	14.4%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	4.113%	20.1	23.4	44.0	219.8
Canada 10-Yr	3.479%	15.7	36.9	39.2	164.1
UK 10-Yr	3.988%	19.4	45.1	67.1	258.0
Germany 10-Yr	2.316%	15.0	29.2	-3.3	208.8
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	4.72%	-0.7%	-0.9%	2.3%	-6.2%
U.S. Investment-Grade Corp	5.21%	-0.6%	-0.8%	4.4%	-5.0%
U.S. High-Yield Corp	7.83%	-0.1%	-0.1%	8.6%	3.9%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	2,033.89	-0.3%	-1.4%	8.6%	11.7%
Silver (spot $/oz)	22.20	-3.3%	-6.7%	0.1%	-3.5%
Copper ($/metric ton)	8,293.25	-2.4%	-2.0%	-6.7%	-15.4%
Oil (WTI spot/bbl)	73.31	-3.3%	2.3%	-5.0%	-19.7%
Oil (Brent spot/bbl)	79.36	-2.9%	3.0%	-5.2%	-14.4%
Natural Gas ($/mmBtu)	1.97	-6.2%	-21.6%	-23.8%	-53.4%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	104.0540	0.8%	2.7%	0.6%	9.1%
CAD/USD	0.7428	-0.2%	-1.6%	-0.5%	-5.9%
USD/CAD	1.3462	0.2%	1.7%	0.5%	6.3%
EUR/USD	1.0774	-0.4%	-2.4%	0.4%	-5.8%
GBP/USD	1.2628	-0.5%	-0.8%	4.8%	-6.7%
AUD/USD	0.6521	-0.7%	-4.3%	-6.3%	-8.5%
USD/JPY	148.1600	0.8%	5.0%	13.0%	28.7%
EUR/JPY	159.6300	0.4%	2.5%	13.5%	21.2%
EUR/GBP	0.8532	0.1%	-1.6%	-4.2%	0.9%
EUR/CHF	0.9420	1.1%	1.4%	-4.7%	-10.9%
USD/SGD	1.3433	0.2%	1.7%	1.4%	0.0%
USD/CNY	7.1949	0.4%	1.3%	6.0%	13.1%
USD/MXN	17.0605	-0.9%	0.5%	-9.8%	-17.2%
USD/BRL	4.9717	0.3%	2.4%	-4.5%	-5.4%

Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Tuesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing.

Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD -1.6% return means the Canadian dollar fell 1.6% vs. the U.S. dollar year to date. USD/JPY 148.16 means 1 U.S. dollar will buy 148.16 yen. USD/JPY 5.0% return means the U.S. dollar rose 5.0% vs. the yen year to date.

Source - Bloomberg; data as of 2/7/24

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As of December 31, 2023

			Investment Banking Services Provided During Past 12 Months	
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Buy [Outperform]	829	57.17	253	30.52
Hold [Sector Perform]	575	39.66	154	26.78
Sell [Underperform]	46	3.17	6	13.04

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