Sector Update

Singapore Banks – Constructive guidance despite a more uncertain environment

Research Team

Equities

Globalisation vs. Slowbalisation

Investment highlights

Following the tail risks flagged out in our global financials sector rating downgrade (Global Financials - Higher growth risks ahead), the 2Y-10Y US Treasury yield curve has inverted for a second time this year reflecting increased recessionary worries by the bond markets. Our house view remains cautious (Investment strategy: Beware of bear rally, focus on selective opportunities) on global equities and recession risks are expected to remain elevated. Other than the treasury yield curve, other key indicators we continue to monitor include the US Conference board leading economic index (which has started to soften) and potential inflection points in the unemployment rate.

Given the financials sector's macro sensitivity and our view that we are likely in the last leg of the rate trade for the sector, we reiterate our earlier advice for sector weights to be prudently managed within investors' portfolios. Our economist expects the Fed funds rate will likely peak in early 2023 (Macroeconomics: US technical recession not real (yet)). Thereafter, market attention could shift towards the potential for a reversal in policy next year should economic growth or inflationary pressures ease more meaningfully. **In terms of sector implications, this suggests a continued mixed outlook for global banks** (Tussle between rate benefits and recession worries) **in the coming quarters**. While banks are entering the downturn with stronger balance sheets compared to past recessions and guidance remains fairly constructive helped by re-opening tailwinds, near-term share price performance will likely remain pressured as downside risks to growth have increased with aggressive rate hikes in 2H22 (Macroeconomics: Fed hikes & recession risks).

The MSCI Singapore Financials Index has lagged the broad Singapore equity market over the past months since our downgrade of the global financials sector and advice to take some profits off the table. Due to the Federal Reserve's (Fed) determination to combat elevated inflation, our economist expects the Fed funds rates may hit 3.75-4% by early 2023 (Macroeconomics: US technical recession not real (yet)). *This implies rate-sensitive Singapore banks should still see net interest income (NII) growth and net interest margins (NIM) expansion in the coming quarters, which is supportive for overall earnings and dividends.*

In this report, we highlight key takeaways from Singapore banks' recent 2Q22 earnings releases, which was a resilient set of results with aggregate sector profits growing ~9% from a year ago. Common sector trends include NII growth and NIM expansion as the rate transmission continued to flow through, which helped to mitigate weaker non-interest income as wealth management and investment banking fees were negatively impacted by weaker capital markets and more cautious investor appetite.

While the broad tone continues to be fairly constructive due to earnings upside from rates and resilient asset quality outlook (supported by current general provisions (GP) levels and recent stress test results), Singapore banks also flagged out higher macro uncertainties.

The overall guidance has turned more circumspect and watchful for spillover risks into Asia from a potential US recession next year amid more elevated geopolitical tensions and inflationary pressures globally, which is in line with our neutral stance on the sector. Looking ahead, while we expect sector provisions to normalize for Singapore banks, we do not expect a material build-up at this point due to solid GP reserves already in place which is close to ~90bps for DBS and UOB, higher than their respective provisions taken in 2020 during the Covid-19 pandemic (~57bps and 83bps of loans for DBS and UOB respectively). Should a soft-landing scenario emerge or macro worries ease into 2023, potential catalysts include improvements in sector return on equity (ROE) ratios and capital management expectations.

Exhibit 1 – Valuations

	Fair Value	Price/Earnings		Price/Book		Dividend Yield (%)		ROE (%)		Total Returns %
		2022E	2023E	2022E	2023E	2022E	2023E	2022E	2023E	
Singapore Financials										
DBS GROUP HOLDINGS LTD (DBS SP)	SGD37.60	11.3	9.5	1.5	1.4	4.4	5.0	13.3	14.8	4.1
UNITED OVERSEAS BANK LTD (UOB SP)	SGD33.00	10.4	8.6	1.0	1.0	4.8	5.6	10.4	12.0	5.4
MSCI SINGAPORE/FINANCE (MXSG0FN)		10.7	9.2	1.2	1.1	4.6	5.3	11.5	12.6	5.7
MSCI SINGAPORE (MXSG)		17.4	14.5	1.4	1.3	3.7	4.1	8.3	9.2	(7.7)

Sources: Bloomberg, Internal estimates (compliance restriction on OCBC)

Resilient 2Q22 results, confidence on managing risks ahead

Singapore banks reported a resilient set of 2Q22 results, with aggregate profits growing ~9% from a year ago driven by rate benefits. Common sector trends include net interest income growth and a faster pace of NIM expansion (DBS +12bps & UOB +9bps QoQ) as the rate transmission continued to flow through, which helped to mitigate weaker non-interest income which fell from a year ago as wealth management and investment banking fees were negatively impacted by weaker capital markets and more cautious investor appetite. As a result, 2Q22 fee income declined -14%QoQ/-12% YoY and -1% QoQ/-5% YoY for DBS and UOB respectively.

On the positives, guidance continues to be constructive for the coming quarters due to further NIM expansion and NII growth expected, which should help to offset softer non-interest income. In particular, DBS (DBS: Solid NIM expansion) sounded relatively more optimistic on this front, with management sharing its view that 2Q22 may mark a bottom in non-interest income for the bank. Previous NIM sensitivities were maintained. DBS expects SGD18-20m additional topline growth for every 1bps of US Fed rate increase. UOB expects robust NIM expansion for the coming two quarters and guided that 4Q22 NIM could be 20bps higher than 2Q22's level. *Our view is that while the positive momentum should continue in 2H22, the pace of NIM expansion could moderate in 2023 as deposit competition picks up*.

Drawing comfort from current buffer of reserves against performing loans: Credit costs remained benign in 2Q22 (at ~5bps and ~22bps for DBS and UOB respectively). The sector has retained its general provisioning levels given higher macro uncertainties but expressed confidence that current buffers (including management overlays) should be sufficient for potential deterioration in asset quality should recession risks increase. DBS expects provisions could normalize towards 20-25bps and does not see material credit cost increase in 2022. Although credit costs could increase 10-

12bps in 2023, DBS's management believes it should still fall within the bank's 20bps guidance. Current GP overlay is worth ~87bps of credit cost buffers (vs the bank's ~83bps of loans seen in 2020 due to the pandemic), and management does not see risks to the buffer being depleted.

UOB's (UOB: Decent 2Q, but guidance trimmed) management shared that while it does not see any systemic weakness in its portfolio, it is taking a conservative stance on allowances. Credit cost should come in at the higher end of its guidance range (~25bps) this year. The bank also expects higher operating expenses due to the integration of the Citi ASEAN acquisition before earnings accretion comes through in 2024E. Its general overlays were maintained (~91bps of reserves against performing loans, vs ~57bps of loans taken in provisions during the pandemic in 2020), with 2Q22 loan provisioning stable at 22bps annualized.

CET1 ratios were stable as of 30 June 2022 (DBS ~14.2% and UOB~13.1%), which suggest excess capital of about SGD4b for DBS (assuming a target level of 13%) while UOB is currently at an optimal level at this point. *We see some potential catalysts ahead for the sector should a soft-landing scenario materialize and recessionary risks ease*. Given DBS' excess capital position (2Q22 CET1 ratio was 14.2%, versus its target CET1 range of 12.5-13.5%), the topic of its capacity for special dividends or buybacks was raised. The bank has guided it would share more details towards year end as it is currently reviewing its capital management plan. In addition, management was optimistic for ROE improvement given NIMs should reach 2% in 2023 while operating leverage could drive its cost to income ratio to the low end of 40%+.

While the broad tone continues to be fairly constructive due to earnings upside from higher rates and resilient asset quality expectations (supported by current GP provision levels and recent stress test results), Singapore banks have flagged out higher macro uncertainties in their results briefings where more tail risks are acknowledged. The overall guidance has turned more circumspect and watchful for spillover risks into Asia from a potential US recession next year amid more elevated geopolitical tensions and inflationary pressures globally.

Exhibit 2 – 2Q22 results highlights

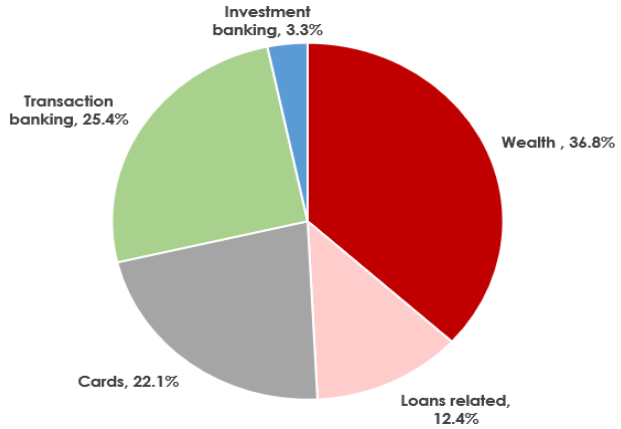
Loan growth	YoY	QoQ
DBS	6.7%	2%
UOB	7.7%	1%
Fee income growth	YoY	QoQ
DBS	-11.5%	-14%
UOB	-4.7%	-1%
Other non-NII growth	YoY	QoQ
DBS	-9.8%	-15%
UOB	11.5%	169%
Cost growth	YoY	QoQ
DBS	7.5%	1%
UOB	11.9%	12%
Pre-provision operating profit growth	YoY	QoQ
DBS	4.3%	1%
UOB	11.7%	17%
Net income growth	YoY	QoQ
DBS	6.6%	1%
UOB	10.9%	23%

Reported NIM	2Q22	YoY	QoQ
DBS	1.58%	13bps	12bps
UOB	1.67%	9bps	9bps
Loan deposit ratio	2Q22	YoY	QoQ
DBS	81.6%	-2ppt	0.4ppt
UOB	89.8%	1.7ppt	1.4ppt
Credit cost	2Q22	YoY	QoQ
DBS	5bps	-1bp	-1bps
UOB	22bps	-5bps	3bps
Cost to income ratio	2Q22	YoY	QoQ
DBS	43.7%	0.7ppt	-0.2ppt
UOB	43.8%	0.1ppt	-1.1ppt
Non performing loan ratio	2Q22	YoY	QoQ
DBS	1.3%	-23bps	-3bps
UOB	1.7%	16bps	7bps
Return on equity	2Q22	YoY	QoQ
DBS	13.5%	0.7ppt	0.3ppt
UOB	10.6%	0.9ppt	1.7ppt

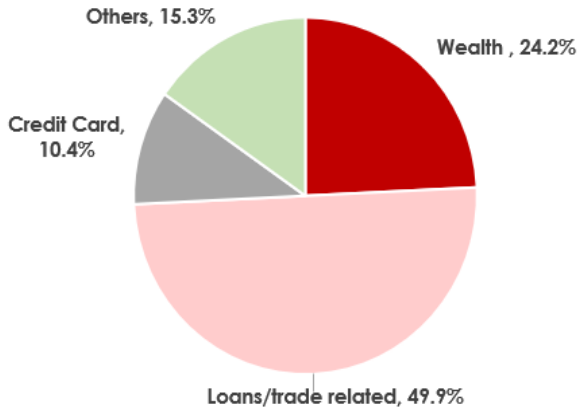
Source: Companies (group compliance restriction on OCBC)

Exhibit 3 – 2Q22 fee income breakdown, by segments

DBS Group Holdings



United Overseas Bank



Source: Companies

Exhibit 4 – 1H22 results summary

DBS Group Holdings

SGD mn	1H21	1H22	%
Net interest income	4,196	4,641	11%
Net fee & commission income	1,821	1,659	-9%
Other non-interest income	1,426	1,239	-13%
Total income	7,443	7,539	1%
Operating expenses	3,130	3,302	5%
Profit before allowances	4,313	4,237	-2%
Allowances	89	101	13%
Profit before tax	4,224	4,136	-2%
Net profit	3,712	3,616	-3%

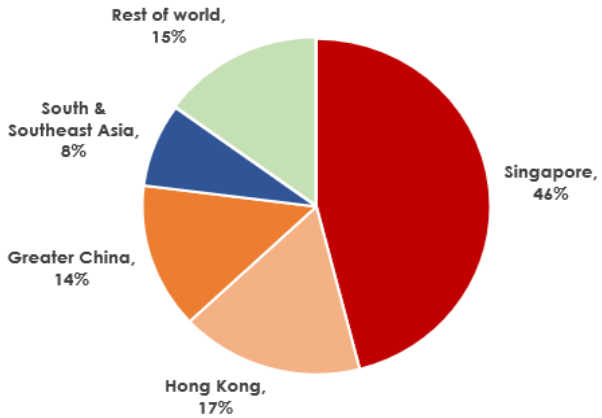
United Overseas Bank

SGD m	1H21	1H22	Chg
Net interest income	3,107	3,549	14%
Net fee income	1,200	1,139	-5%
Others	596	374	-37%
Total income	4,903	5,061	3%
Total expenses	2,146	2,241	4%
Operating profit	2,757	2,820	2%
Impairment charge	383	315	-18%
Assoc & JV	70	52	-27%
Net profit	2011	2018	0%

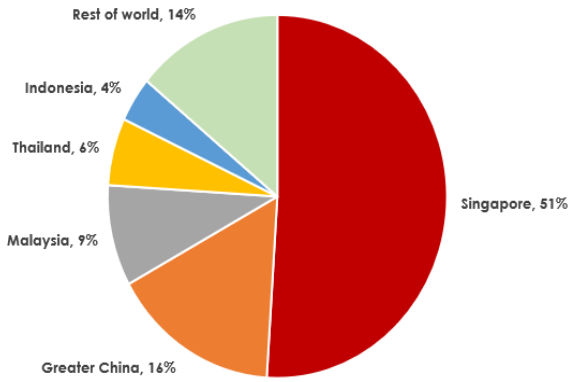
Source: Companies

Exhibit 5 – 1H22 gross loans breakdown by geography

DBS Group Holdings



United Overseas Bank



Source: Companies

Mindful of higher macro risks, but limited concerns on overall asset quality of loan books at this point

Bank managements have emphasized their relative sanguine stance on the asset quality outlook of their loan portfolios, following recent stress tests which suggest the sector's loan portfolios should still remain relatively resilient even in a more stressed macro environment. The unemployment rate is a key indicator being watched, which remains low due to a tight labour market and supports the sector's base case of no recession for the Singapore economy at this point.

Buffers remain strong with slight differences in forward looking comments on general allowances. DBS kept its general allowance steady (~SGD3.74b) and does not expect to increase this further given its overlays in place are already above what the baseline model suggests. For UOB, while its general overlay (SGD2.9b) was unchanged, management guided it may build up slightly more this year and does not anticipate writing back for this year in view of macro uncertainties.

Discussion also evolved around the Singapore mortgage book, which is expected to see stable asset quality (in line with historical performance) even if mortgage rates continue to increase. This is due to the majority of the Singapore mortgage book for the sector being owner occupied (>80%) and buffers from LTVs (below 50%). Although the SME segment is cited as another area which could be more vulnerable during periods of economic downturns, this makes up a smaller proportion of the loan books with collateral in place, and typically consists of working capital needs, with sustainable financing/ESG focused investments remaining areas of potential growth.

Sector has low exposure to China onshore real estate loans

China's recovery outlook and geopolitical concerns were discussed. More colour was also provided by the sector on their onshore Chinese real estate loans exposure, which is limited at low single-digit percentage (<1%) of banks' total loans. DBS' Chinese onshore property loans exposure is estimated at ~SGD16b, which comprises of ~SGD2b to half a dozen Mainland Chinese developers, while the majority ~SGD14b is from network clients (including Singapore property developers). UOB has about SGD3b of China onshore property loans. Stress tests by the banks continue to show risks are manageable.

Exhibit 6 - Non-performing loans, provisions & CET1 ratios

DBS Group Holdings

S$ in millions	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22
Non performing loans (NPLs)	5,752	6,043	6,059	5,899	6,091	6,166	5,290	5,491	5,491
NPL Ratio	**1.5%**	**1.6%**	**1.6%**	**1.5%**	**1.5%**	**1.5%**	**1.3%**	**1.3%**	**1.3%**
NPL Coverage	**105%**	**110%**	**109%**	**112%**	**107%**	**102%**	**115%**	**106%**	**112%**
General provisions (GP)	3,799	4,017	4,312	4,131	4,045	3,918	3,876	3,754	3,737
Specific provisions (SP)	2,922	2,969	3,014	3,060	3,156	3,143	2,926	3,060	2,955
GP/loans (bps)	**100**	**106**	**114**	**105**	**100**	**95**	**93**	**89**	**87**
CET1	**13.7%**	**13.9%**	**13.9%**	**14.3%**	**14.5%**	**14.5%**	**14.4%**	**14.0%**	**14.2%**

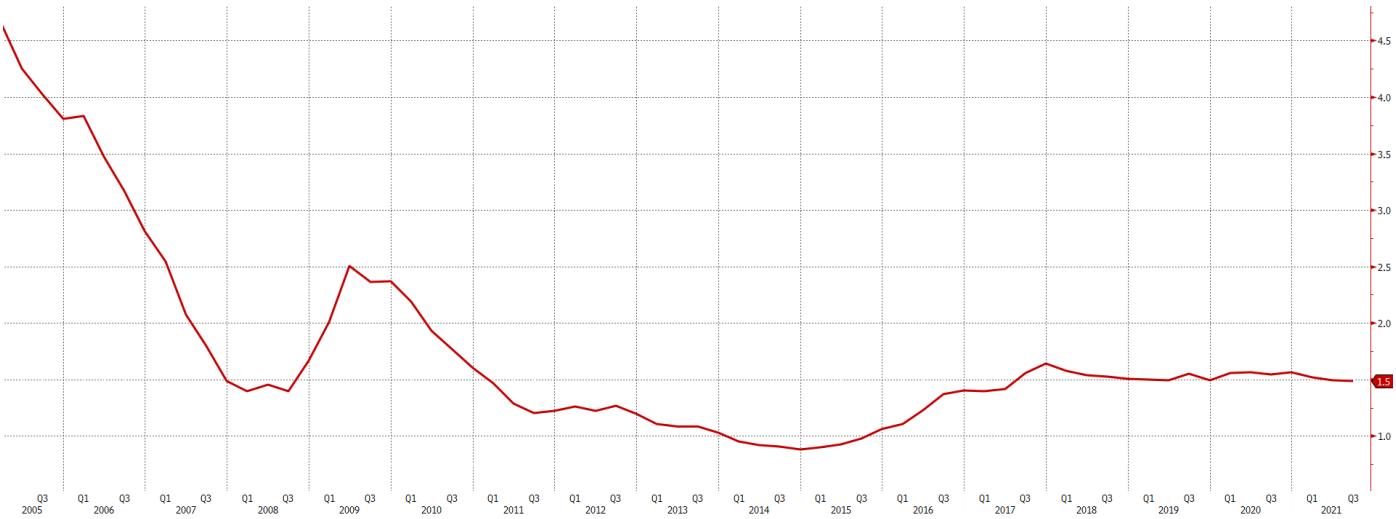
Source: Company

United Overseas Bank

S$ in million	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22
Non performing loans (NPLs)	4,529	4,230	4,520	4,399	4,507	4,591	5,030	5,120	5,374
NPL Ratio	**1.61%**	**1.51%**	**1.61%**	**1.50%**	**1.51%**	**1.50%**	**1.62%**	**1.60%**	**1.67%**
NPL Coverage	**82%**	**94%**	**93%**	**95%**	**93%**	**92%**	**81%**	**80%**	**77%**
General provisions (GP)	2,391	2,712	2,873	3,003	3,040	3,046	2,941	2,969	2,912
Specific provisions (SP)	1,664	1,664	1,692	1,693	1,558	1,627	1,556	1,638	1,643
GP/loans (bps)	**85**	**97**	**102**	**102**	**102**	**100**	**95**	**93**	**91**
CET1	**14.0%**	**14.0%**	**14.7%**	**14.3%**	**14.2%**	**13.5%**	**13.5%**	**13.1%**	**13.1%**

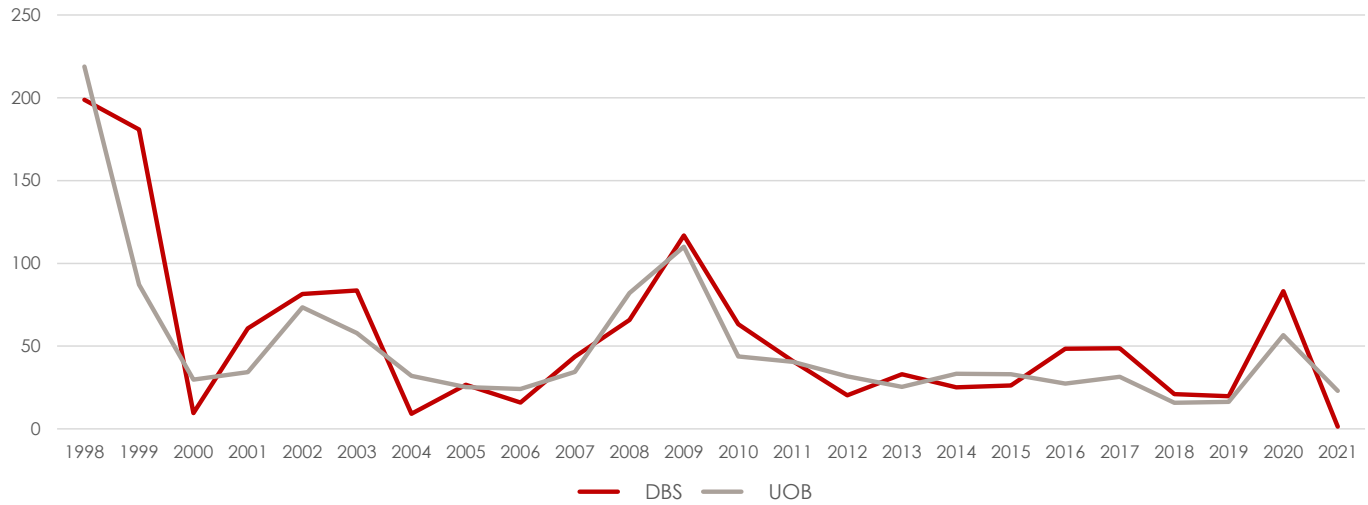
Source: Company

Exhibit 7: Singapore banks sector – Historical NPL (non-performing loans) ratio



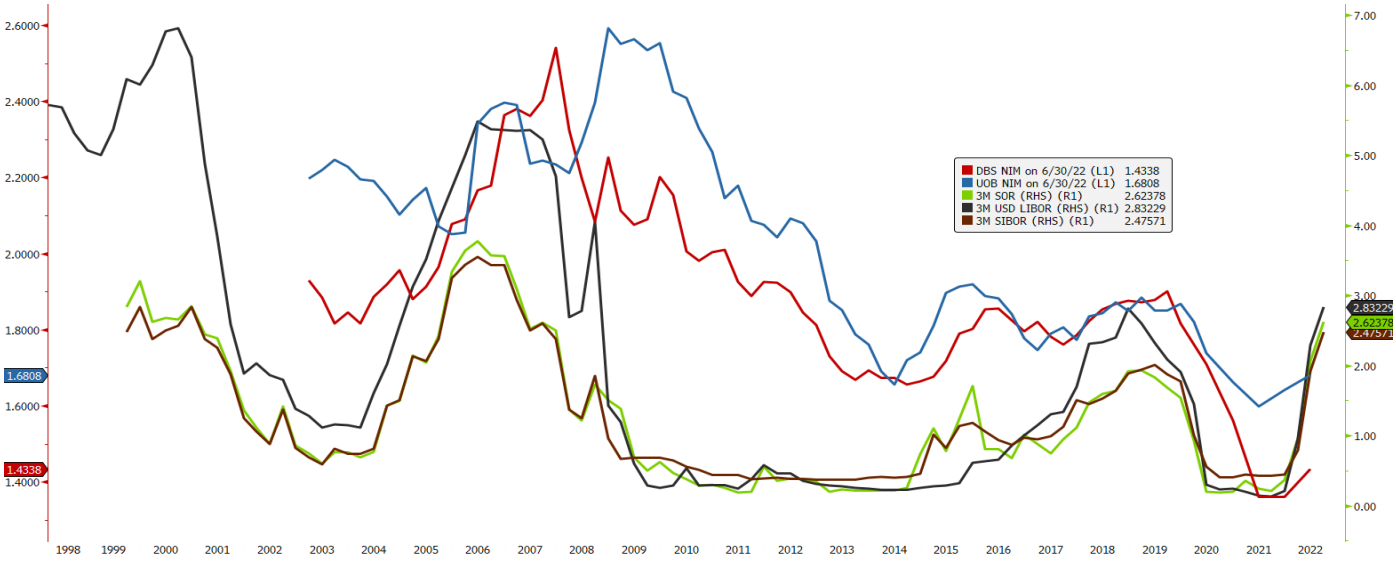
Sources: Bloomberg, Monetary Authority of Singapore, Companies, Internal estimates

Exhibit 8: Singapore banks (DBS, UOB) – Historical provisions (basis points of loans)



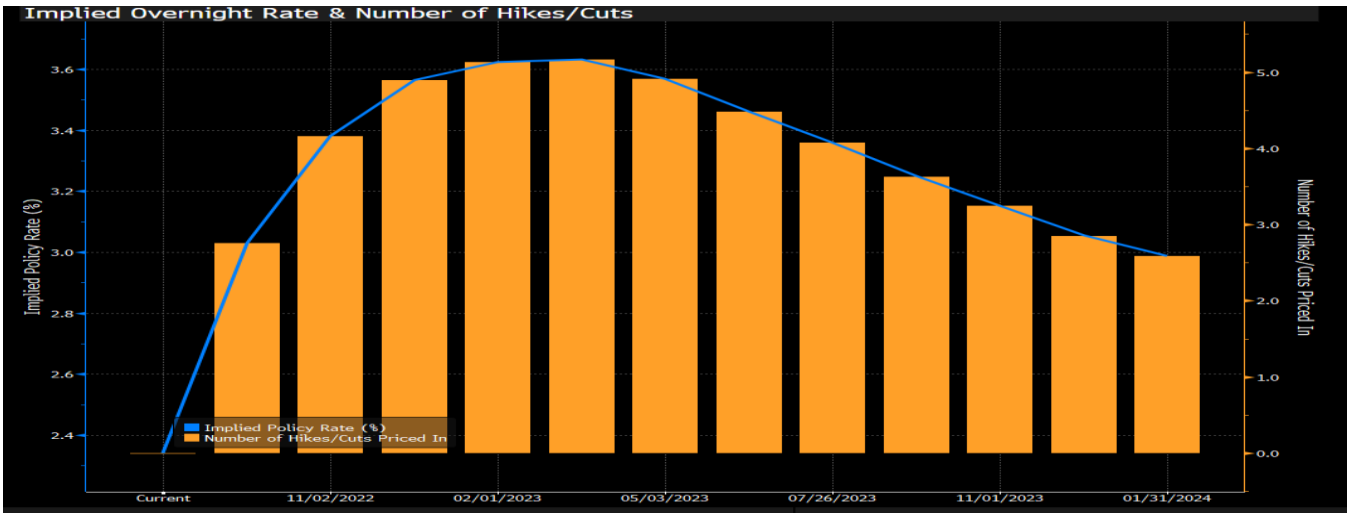
Sources: Companies, Internal estimates

Exhibit 9 - Singapore banks NIMs & interest rates



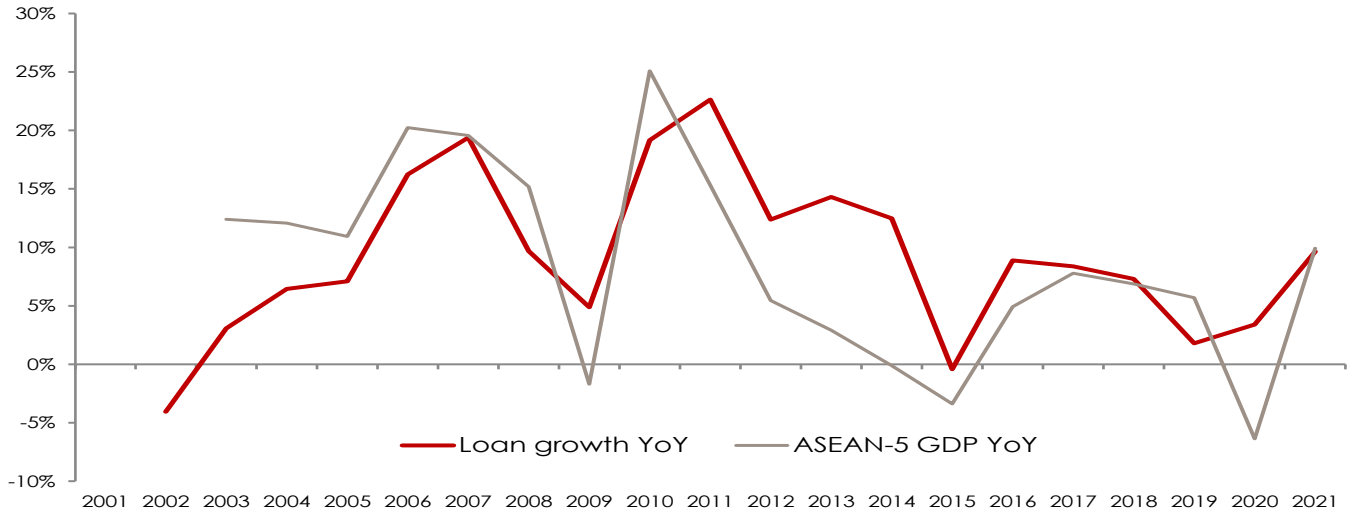
Source: Bloomberg

Exhibit 10 - Implied overnight rate & number of Fed funds hikes/cuts



Source: Bloomberg

Exhibit 11- Historical loan growth and ASEAN-5 GDP growth rates



Sources: Bloomberg, Internal estimates

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