MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 006 // **18 January 2021**

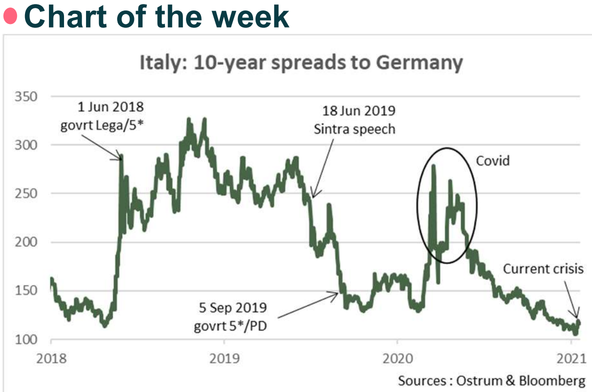
Topic of the week: A game changer for banks?

- **We show that the health of the banking sector is of key importance for the implementation of monetary policy. Hence the ECB's attention to the sector.**
- **European banks are still plagued with many issues and low profitability, we show that they have also undergone profound structural changes and have a very different risk profile than it used to.**
- **The more favorable guidance, just released by the ECB, on banks merger is not a game changer but could hasten the process of consolidation.**

Market review: Profit taking across financial markets

- **Biden announces $1.9T relief plan**
- **Political risk returns in Italy**
- **T-note yield below 1.10%**
- **Equities consolidate towards weekly close**

Chart of the week



The current Italian political crisis is obviously less acute than that of Q2 2018. The very benign reaction of the markets is however impressive. The 10-year spread remained in a 10 bp range.

This owes much to the ECB's action and is yet another proof that QE is not only about reducing yields but also about compressing volatility.

Figure of the week

1.9T

Source : Ostrum AM

Joe Biden announced a $1.9T economic relief program. But the complexity of the US budget process and the acrimonious political climate in Washington cast doubt on the size of the effective plan.

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● **Topic of the week**

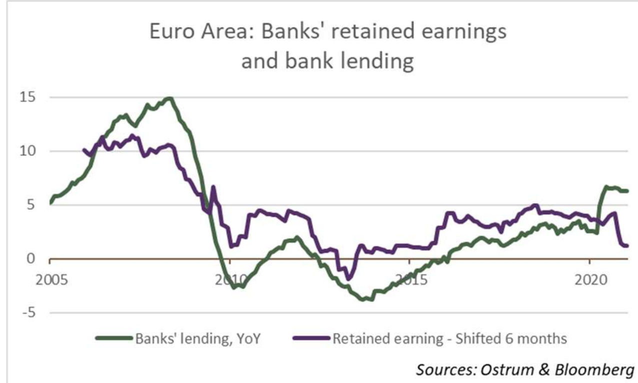
A game changer for banks?

The ECB just made it easier for Banks to merge. The health of the banking system is key for monetary policy, and often a dimension overlooked, as it guaranties the efficiency of the transmission mechanism. While the sector is still plagued with a number of issues, we highlight that structural changes have been reshaping the sector over the past decade. The recent ECB change is not a game changer, the sector has been steadily consolidating for two decades, but it could hasten the process and maybe take it to the next level with large mergers and cross-border mergers.

The ECB has just released a long-awaited updated “Guide on the supervisory approach to consolidation in the banking sector” https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.guideconsolidation2101~fb6f871dc2.en.pdf
An important document indeed, albeit a very technical one, that results in facilitating mergers in the banking system in Europe. Below we first show that the health of the financial system is one key element in the transmission mechanism of monetary policy, a dimension often overlooked. Then we show that the banking system has gone through large structural changes, especially since the launch of the Banking Union at the end of 2014. Finally, we show how these modified rules could foster further changes in the banking sector in Europe. These, we believe, are key elements for the funding of the economy and for financial stability in the future.

A healthy banking system please!

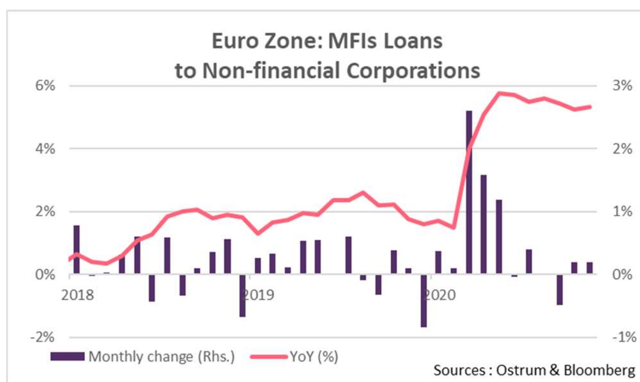
Maximizing the profitability of the private sector is not part of a Central Bank’s objective. And yet, we would argue that the profitability of the banking system at large, is one important element to consider. The chart below illustrates why. The level of banks’ retained earnings evolves in very close tandem with banks’ lending dynamic. An econometric analysis would even show that **retained earnings provide a good leading indicator to lending as they are actually ahead by about six months.**



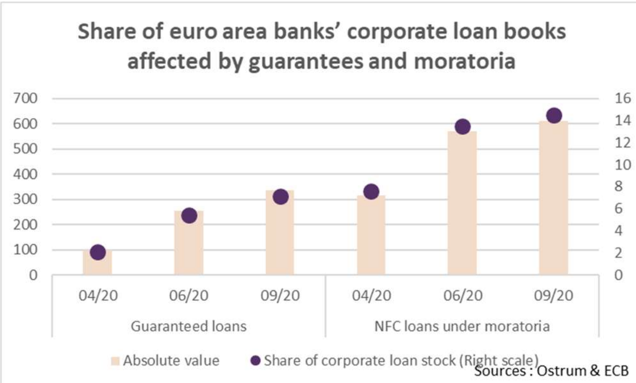
Why is that so? The intuition is simple. Imagine bank ABC with a return on equity of 6% and a payout ratio of 50% (they distribute half of their profits), retained earnings would be 3%. This means that the capital of bank ABC will increase by 3%. With its increased capital, the bank can increase its all balance sheet by the same 3% while keeping its leverage ratio constant. If there is no drastic reallocation in the asset size of the balance sheet, the loan book can, as well, increase proportionally hence by 3%. In short, the ability of a bank to grow its loan book and assets depends on its capacity to increase its retained earnings, hence its profitability.

The ECB seems to be on that line too. This argument has been mentioned, in different shape and forms in past issues of the “Financial Stability Review”. The ECB showed for instance that banks valuation in the stock market is correlated to their lending decision. Former ECB’s board member Peter Praet also used that argument repeatedly in the past.

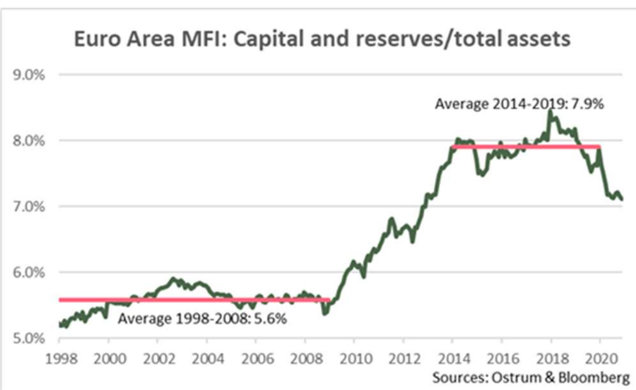
Obviously, this relationship is not cast in stone. Especially recently, loans have increased much faster than retained earnings would have suggested. This is the result of a jump in March to May.



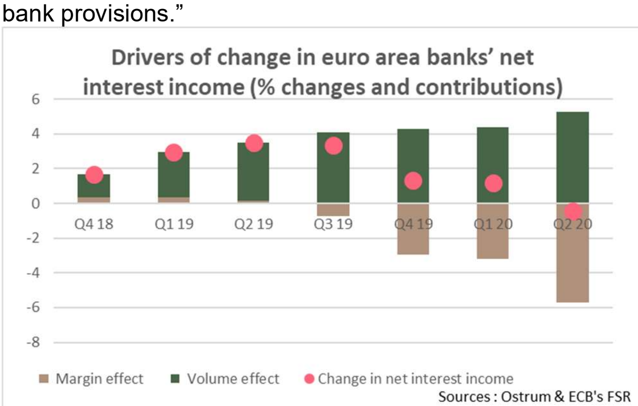
This is courtesy of governments’ incentives, a significant proportion of the banks’ loan book is now affected by guarantees. But is also owes much to a very loose monetary policy and less stringent regulation, the ECB for instance relaxed the some MREL constraints in March to allow banks to lend more.



One issue with that argument is that **banks' capitalization has significantly increased since 2009**. The chart below shows a macro proxy of banks' capital ratio in the Euro Area. We use ECB's aggregate data on the Monetary and Financial Institutions' balance sheet; the account "capital and reserve" was stable around 5.½% before 2009, it had stabilized since 2014 at around 8%. **Consequently, with the same level of profits, the ROE is lower, hence retained earnings. This means that the ability of banks to grow their balance sheet, hence their loan books, has been reduced.**



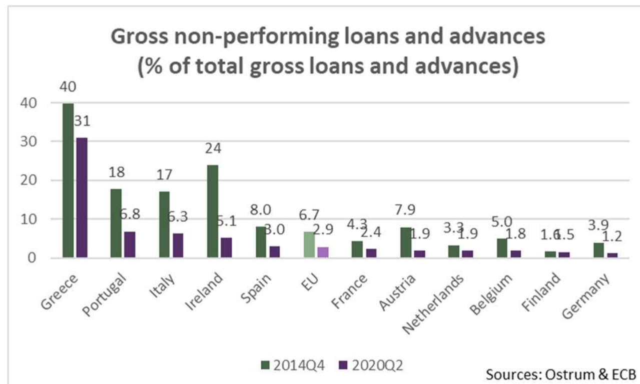
This argument is reinforced by the current economic environment: low rates and a flat curve result in low NIM for banks with consequence on their ability to generate profits. The ECB concluded in a working paper that "the outlook for net interest margins will remain weak, adding to the bank balance sheet stress induced by the pandemic, notwithstanding the mitigating effect of low interest rates on bank provisions."



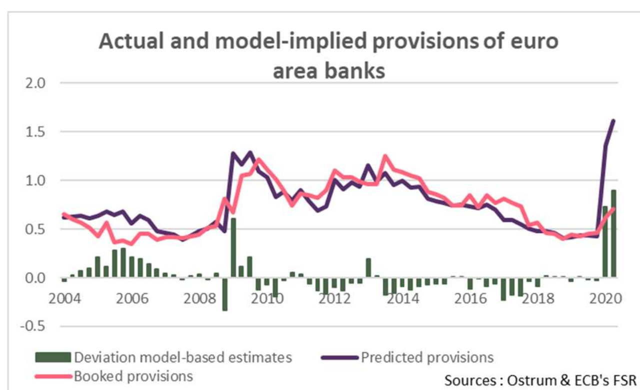
Structural changes

Against this cyclical background, the banking system has undergone important structural changes since the great recession.

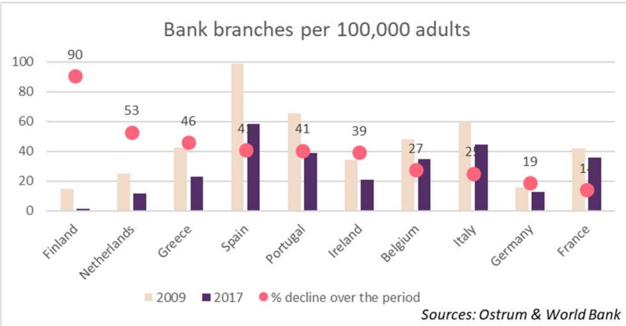
The first point illustrated in the following chart is the ample reduction on NPL. The ratio according to the ECB was just above 8% at the end of 2014 but has dipped below 3% on the latest data. About two thirds of the NPL ratio has been cancelled, a proportion which is quite similar in Spain, Italy or Portugal. The heritage from the past cycle is not fully absorbed, but with insight the cleaning sweep has been quite forceful.



One must be careful though with those improvements. The following chart is taken from the latest ECB's Financial Stability Review, it shows **a worrying discrepancy between a model-based estimate of provisions and what has been actually booked.** We would underline however that ECB's model seems quite unfavorable: with the amount of government guarantees on new loans, it is surprising to find such a high theoretical level of provisions and the reality might be less ugly.

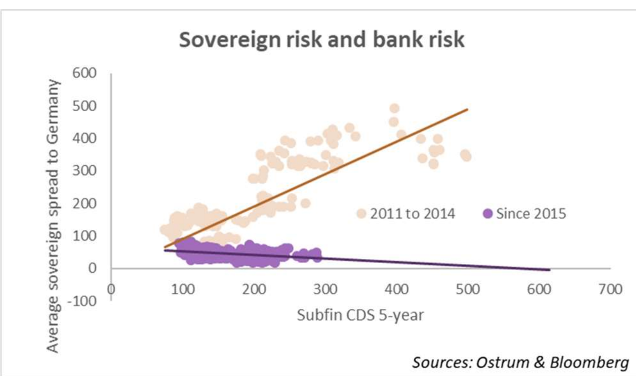


It is also worth mentioning that, **while the revenue side was under pressure, banks have trimmed their costs.** The below data show that the number of branches has been cut quite aggressively by banks since the great recession. Likewise, the ECB statistics show a 17% decline in the number of banks employees between 2008 and 2019, a 385k decline over the period.

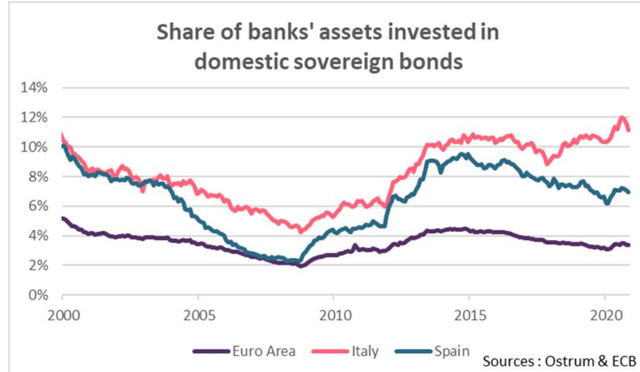


Finally, the risk profile has been altered too for the better. One of the issues during the crisis at the beginning of the past decade was the negative feedback loop between the sovereign and the banks, also called the sovereign-bank nexus. A deterioration of the situation of the banks was prompting expectations that the taxpayer would have to step-in, hence that the public finances would be affected, this result in widening sovereign spreads and dent back the banking system. And indeed, the chart below shows that the risk for banks and that of the sovereign were very correlated indeed until 2014.

The introduction of the Banking Union in April 2014 has done a lot to change this pattern. Thereafter changes in the risk profile of banks had little if any effect on sovereigns.



If the change is quite impressive (especially for veterans of the last decade!), here too we must add a note of cautiousness. Lately, holdings of domestic bonds have increased again. Especially so in 2020, the generous TLTRO provided by the ECB have been used by a number of banks to embark on a carry trade and purchase domestic bonds. Although this helps financing governments and provides a risk-free lofty carry trade for banks, it also increases their sensitivity to sovereign risk. The sovereign-bank nexus could thus re-emerge and might not be as dead as recent market patterns suggest.



A wave of mergers?

In this context, could we witness a wave of mergers in the banking sector in Europe?

ECB new guidance, in a nutshell

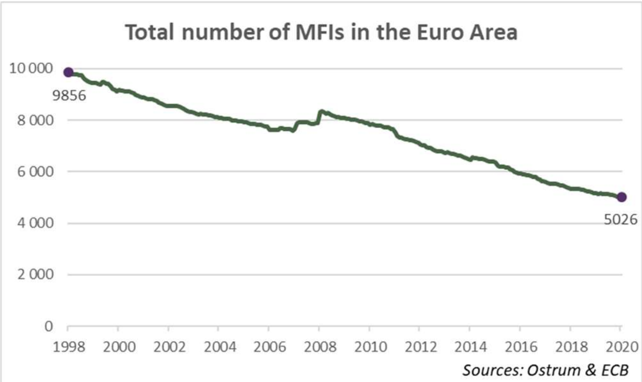
In a nutshell, the above-mentioned ECB's Guide formally confirms that the badwill can be used during a merger. In ECB's word, the badwill is defined as follows: "Badwill, also known as negative goodwill, occurs when a company purchases an asset at less than its net fair market value. Typically, badwill occurs when one company purchases another at a price that is below its book value." Hence the difference between the book value of bank and the price paid by the acquirer can be booked as fresh capital in the new entity. However, "it is generally expected that the potential profits from badwill will not be distributed to the shareholders of the combined entity".

Other measures are also aimed at facilitating mergers. Internal models can be used, albeit for "a limited period of time". Last, importantly, the capital requirement of the merged entity will be derived from the level of the two pre-existing entities and the ECB will communicate the targeted level during the operation of merger. In the past mergers have often led the ECB to impose higher capital ratio which has made banks reticent to embark in some operations.

Continuation rather than revolution

These measures are the result of a consultation launched about three months ago. They are aimed at being an incentive for banks to purchase other institutions at a discounted value.

The first point to highlight is that consolidation is actually well underway and has been so since the launch of the Euro. The ECB provides the number of financial institutions, and as shown in the chart below, that number has been halved since 1998. It is worth highlighting that the numbers have been lifted by new joiners, Greece in 2001, Slovenia in 2007, Cyprus and Malta in 2008, Slovakia in 2009, Estonia in 2011, Latvia in 2014 and finally Lithuania in 2015. If we were to strip out these additions, the decline would be over 50%.



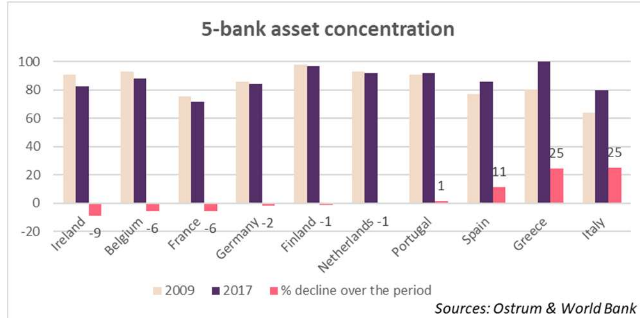
Where this could lead us

Rather than a game changer, the ECB's new guidance could thus be a facilitator and hasten a decade long process of consolidation. The argument of the potential use of the badwill is potentially a far reaching one. If we use the Euro Area bank index (SX7E Index), the price to book is 0.51, and only one of the 21 banks trade above book value: KBC that trades at 1.3 times. A larger index, with smaller banks, would give an even more dire result.

As we see the measure is thus far from negligible.

What could change compared to the trend on the number of MFIs we highlight above is two dimensions.
First, while the number of MFIs is indeed rapidly and steadily declining, this is essentially a story about small, or very small, entities that disappear. The World Bank runs a concentration measure for the banking sector, using the assets of the top five banks. And the trend is nowhere near what is suggested by the reduction in the number of MFIs. Concentration has even declined on WB's measure in 6 out of the 10 countries shown in the chart below, including in France, Germany and the Netherlands. **Higher concentration would thus request mergers of larger entities which have remained relatively rare so far. This could be one change in the foreseeable future.**

Second, cross-border mergers. Regulation, and other considerations have so far made large cross-border mergers very difficult. Despite repeated rumors in the past of potential high-profile bank mergers, which never came to pass. Such mergers would be very welcomed, transnational banks would be a very powerful tool to further kill the sovereign-bank nexus. It would thus have an impact on Euro Area financial stability.



Conclusion: you can hear a tree fall; you don't hear the forest grow

The banking sector in Europe has been plagued by a number of issues, low growth and very low rates have impaired profitability. This led several weak banks to run into severe issues. Those challenges are still here, and the heritage of the pandemic will also have to be digested.
Meanwhile though the sector has also deeply evolved over the past decade. Although more silent, those changes create a sector with lower costs, a business model that is changing and a risk profile that has been cut compared to the pre-sovereign crisis levels.

This is of paramount importance for the ECB as banks are the key transmission mechanism for monetary policy. The recent change in the guidance for mergers is probably not a game changer for the sector as a whole but is likely to hasten and broaden the process of consolidation. On the opposite, the many problems faced by the banks is a headwind that leads us to be cautious in terms of merger expectations.

Beyond the current trend a new challenge emerges with the emergence of fintech and the move of some large tech companies into the financial sphere. This could lead to even more profound changes in the sector. Banque de France's governor François Villeroy de Galhau even considers it to be the main challenge for banks over the next decade. This is potentially highly disruptive in three dimensions: competition as it will remove barriers to entry, business model as some part of the bank services could be disintermediated and obviously in terms of cybersecurity.

Stéphane Déo

Market review

Profit-taking across financial markets

Despite $1.9Tstimulus plan announced by Biden, T-note yields drifted below 1.10%. In Italy, Renzi pulled his support to the Conte government though BTP widening pressure remained muted. Credit underperformed in the wake of profit taking in equity space.

Just days before his inauguration, Joe Biden communicated an economic relief program. The announced measures total $1.9T but the complexity of the US budget process and the acrimonious political climate in Washington cast doubt on the size of the effective plan. Funding for vaccines, income transfers to US households and federal unemployment insurance (raised to $400 a week until September) may get broad support from lawmakers. However, state and local government bailouts worth $350b are unlikely to pass the Senate. In turn, tax hikes, included in Joe Biden's platform, have been left aside. Tax hikes may come next year at the earliest. In addition, infrastructure spending linked to the fight against climate change will be postponed. Lockdown linked to the epidemic resulted in rising initial jobless claims last week. Retail sales ended year 2020 on a softer note despite higher car sales.

In the euro area, political risk is back. Matteo Renzi pulled its support from the Conte government criticizing the planned use of European funds. The Italia Viva leader floated the idea of an ESM loan to fund an increase in healthcare spending. The Italian center-left will try to avoid early elections, which would likely turn in favor of Salvini's right-wing Lega. In parallel, the Dutch government resigned following a scandal linked to social transfers.

T-note yields spiked to 1.18% early on last week until the 10-year bond auction sparked a trend reversal in markets. The yield on US benchmark notes traded down to 1.09% at weekly close. The bearish consensus, magnified by speculative short futures positions at the back end, proved misplaced as Jerome Powell ruled out tapering asset purchases in the near term. Fed policy support will adjust to future Federal borrowing needs. The quarterly refunding announcement of the US Treasury will be of importance given the size of maturing treasury bills in the months ahead. Yield curve flattening also responded to weaker equities at the end of last week.

In the wake of the US markets, Bund yields traded as high as -0,46%before drifting lower to a -0,55% close. The political backdrop sparked short-lived tensions in BTP spreads (122bp high) though a lack of attractive alternatives to Italian bonds and the possibility of ESM loans worth as much as 2pp of GDP at mid-swap plus 10bp may limit the upside on spreads. Nevertheless, relative richness in BTP spreads could point to spreads rising to a 130-140bp range in the near term. Spain's 10-year Bono syndication was let with large demand albeit the order book shrank after a revised spread guidance. Competition among bond issuers may have forced enhanced selectivity on the part of investors lately.

As concerns euro IG credit, spreads (91bp) widened by 4bp last week. Primary market activity 514b issued last week) slowed last week, yet 2021 issuance is 60% higher so far than the same period last year. The non-financial sector is overrepresented whilst senior financial debt deals have diminished. The latest ECB measures, including the 1-year extension of the TLTRO bonus rate scheme, may contribute to a reduction in banks' market borrowing. Similarly, bank interests in euro area money markets are very limited at present so that Euribor 12 months rates now trade below the ECB's deposit rate (-0,50%). Final credit fund flows have bounced from profit-taking outflows in 4q20.

The European high yield market went through a soft patch last Tuesday, amid increased selling pressure in the BB-rated group. Richness in the latest bond issues did weigh on secondary market quotes. Furthermore, the auction of defaulted Europcar bonds failed. Deliverable bonds were unavailable so that recovery rates shot up to 100% leaving protection buyers with 0%. It is worth noting that iTraxx Crossover (+17bp) is wider so far in 2021 whilst the cash high yield bond market tightened modestly (-6pb).

In equity markets, solid US bank earnings did not prevent a pullback in equity indices late last week ahead of MLK day. Banks take back part of loan-loss provisions accumulated through the pandemic. That said, utilities outperformed the most as cyclical sectors took a hit from a surprisingly strong dollar. The expiration of equity derivatives likely exacerbated the move lower on Friday.

In Europe, the Euro Stoxx lost 0,7% in five trading days. Technology and health care are the only two sectors with positive performances. The decline in the euro cushion the downside for European equities. That said, EPS forecasts for 40% growth in 2021 appear quite optimistic given the latest economic developments.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	18-Jan-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.72 %	-2	+1	-2
EUR Bunds 10y	-0.52%	-3	+5	+5
EUR Bunds 2s10s	19 bp	-1	+4	+6
USD Treasuries 2y	0.13 %	-1	+1	+1
USD Treasuries 10y	1.08 %	-6	+14	+17
USD Treasuries 2s10s	95 bp	-5	+13	+16
GBP Gilt 10y	0.3 %	-1	+5	+10
JPY JGB 10y	0.06 %	+2	+5	+3
€ Sovereign Spreads (10y)	**18-Jan-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	23 bp	+2	-2	0
Italy	117 bp	+11	+3	+6
Spain	61 bp	+6	-1	-1
Inflation Break-evens (10y)	**18-Jan-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	95 bp	+3	+12	-
USD TIPS	209 bp	+2	+13	+10
GBP Gilt Index-Linked	305 bp	+4	-4	+5
EUR Credit Indices	**18-Jan-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	91 bp	+4	-2	-1
EUR Agencies OAS	40 bp	+2	-2	-1
EUR Securitized - Covered OAS	32 bp	+1	-1	-1
EUR Pan-European High Yield OAS	352 bp	+11	-10	-6
EUR/USD CDS Indices 5y	**18-Jan-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	51 bp	+3	+3	+4
iTraxx Crossover	261 bp	+8	+17	+19
CDX IG	52 bp	+1	-1	+2
CDX High Yield	304 bp	+6	+5	+11
Emerging Markets	**18-Jan-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	358 bp	+13	-2	+6
Currencies	**18-Jan-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.207	-0.81	-1.53	-1.28
GBP/USD	$1.355	+0.21	+0.23	-0.71
USD/JPY	¥103.73	+0.43	-0.41	-0.41
Commodity Futures	**18-Jan-21**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$55.0	-$0.7	$2.7	$3.2
Gold	$1 836.7	-$12.0	-$44.6	-$57.6
Equity Market Indices	**18-Jan-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	3 768	-1.48	1.59	0.32
EuroStoxx 50	3 599	-0.60	1.50	1.30
CAC 40	5 615	-0.84	1.58	1.15
Nikkei 225	28 242	0.37	5.53	2.91
Shanghai Composite	3 596	1.83	5.93	3.55
VIX - Implied Volatility Index	24.34	12.89	12.84	6.99

Source: Bloomberg, Ostrum Asset Management

Additional notes

Ostrum Asset Management

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