Macro Keys

Europe: Where are we wrong if markets are right?

Economics

Global

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Markets are gloomy about the financial sector and the ECB's effectiveness
We remain reasonably confident that Europe can avoid a major macro slowdown, but current market pricing suggests otherwise. Where are we wrong if the markets turn out to be right? The markets' gloomy assessment could be based on a more pessimistic assessment of external risks (China/EM/US), European politics, or the negative impact of the market sell-off on European growth through wealth and sentiment effects. More importantly, however, the markets seem to have taken a more negative view than we have on the severity of problems in the financial sector and their likely fallout on the European credit channel. The markets also seem to suspect that the ECB is running out of options to lift the economy.

Europe's resilience: So far so good, but markets don't seem convinced

In our report 'Can Europe remain resilient?' (15 February), we presented the most important short-term indicators that will help us track the Eurozone's economic performance amid much-increased risks. So far, Europe has held up respectably – we think this is thanks to a pattern of growth that is heavily geared towards domestic demand, rather than exports. Going forward, we suspect that sentiment and activity in the export-orientated industrial sector will probably suffer setbacks, which might already have been evident in the January manufacturing PMIs and the German Ifo. However, the industrial sector makes up less than 20% of GDP, so the much more important question is whether potential weakness in industry would spill over into the services sectors, which represent the bulk of the Eurozone economy (74%). So far, we are reasonably confident that this spillover can be avoided, as fiscal stimulus, low oil prices and real wage growth provide support to domestic demand. We therefore believe a broader Eurozone slowdown can be prevented, and forecast GDP growth of 1.6% in 2016 and 1.7% in 2017 (after 1.5% in 2015). This projection already includes a weaker external outlook; we downgraded our 2016 growth forecast from 1.8% to 1.6% on 3 February – see Europe: Scaling back 2016 GDP growth.

But judging by the price action in equity markets, our reasonably constructive view is being seriously questioned. Equity markets seem to be moving towards a scenario where European earnings will not recover, even after five years of no growth, and that the economy is now falling back to a low-growth environment (see Oil drives 'value gap' to 2000 tech bubble extreme, 11 February). Similarly, Bund yields have declined further, and the rates market is pricing in a significant decline in core inflation going forward. This raises the question: Are we too complacent? Where are we wrong if the markets turn out to be right?

In our view, the market's pessimism could reflect one of the following concerns, or a combination of them:

- First, major damage to the European banking sector and new setbacks for the credit mechanism, aggravated by concerns over negative deposit rates and an untested new European resolution mechanism;
- Second, the ECB lacking effective tools to help the Eurozone overcome its cyclical and structural sluggishness;
- Third, Europe being exposed to much bigger external risks (China, EM, US) than we anticipate;
- Fourth, the equity market sell-off itself inflicting major damage on Eurozone economic activity, through confidence and wealth effects;
- Last but not least, European politics undermining economic confidence.

Of these five concerns, two (external risks and politics) are not new, and for one of the others (confidence and wealth effects) we are, based on historical experience, reasonably confident that it should not be a major risk. However, concerns about the banking sector and ECB policy are more difficult to assess, in our view, and potentially more damaging to the outlook.

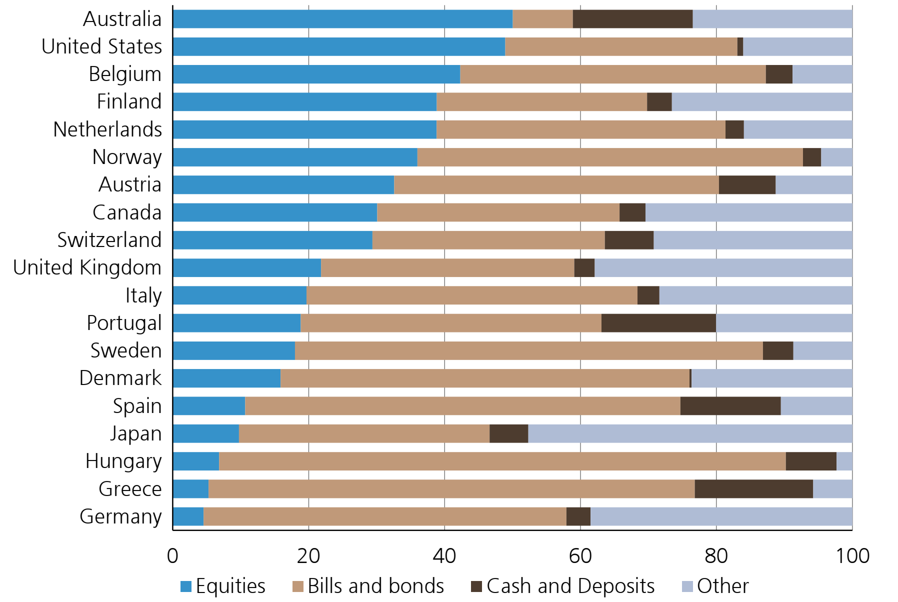
Are we underestimating external risks?

Current market pricing in Europe might be the result of investors taking a much more pessimistic view on China/EM and the US than the UBS house view (Do the facts support the Super Bears?, 15 February 2016; Rising claims, falling productivity, weaker GDP, 4 February 2016). We acknowledge that a hard landing in China or a US recession would hit Europe hard (see China risks for Europe, 26 August 2015), but we regard this as the risk scenario, not the base-case scenario. In any event, we have argued that, for external disturbances to inflict major damage on the Eurozone economy, the weakness would have to undermine not just the export sector (where some damage does seem likely), but spread from there into the service sectors. We see a good chance that this will be avoided, but we could be wrong, of course.

Could the equity sell-off undermine sentiment and hence growth?

According to this line of argument, the equity sell-off could trigger a substantial pull-back in household and corporate confidence, through sentiment and wealth effects, and thus hit household consumption, investment and employment. However, based on historical evidence, this risk does not appear particularly substantial. The share of equity in European savers' portfolios is not very high, so household wealth effects should be limited. Also, on historical evidence, it is difficult to establish a strong *causal* link between stock market performance and corporate sentiment. We are therefore sceptical that the equity market sell-off itself could turn into an *independent* driver of economic performance (i.e. above and beyond just reflecting a weaker global outlook).

Figure 1: Pension fund asset allocation, OECD, 2014



Source: OECD, 'Pension markets in focus, 2015',

Could European politics undermine economic resilience in Europe?

We acknowledge that the European political set-up is complicated, with the markets weighing the political/economic policy prospects in Portugal, Spain and Greece, the outlook for the UK referendum on EU membership, and Europe's strategy in managing the large-scale influx of refugees. The risk scenario of Brexit or of a breakdown of the Schengen agreement could have negative implications for sentiment and economic activity. But we see these challenges more as a headwind to markets than the driver of the current sell-off. Put differently, justifying current market pricing with political risk would imply that a number of political worst-case scenarios would materialise, in our view.

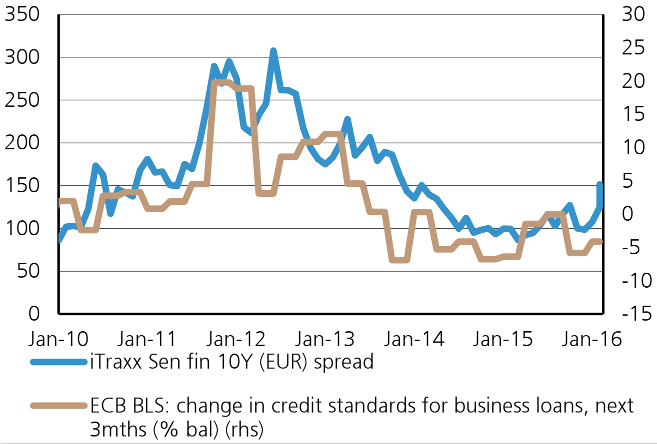
Will new problems in the financial sector derail Eurozone growth?

We have been highlighting easing credit conditions as one of the drivers of our constructive growth outlook for the Eurozone. But could the current sell-off in financial sector stocks signal deeper problems in the Eurozone banking sector – problems that might reverse the trend of easing credit conditions?

According to the UBS banks team, the key problem of the European banking system is not questionable solvency. They also point out that the average exposure to the oil and gas sector is around 3% of loans, and hence manageable (Annex Figure 4). Instead, our colleagues think the sell-off in banking stocks is a reflection of poor expected returns, in an environment of negative deposit rates and challenging regulation (See: Shock and Aw(ful): Bank equities imply poor ROEs, not insolvent institutions, Napier/Jevremovic, 15 February 2016).

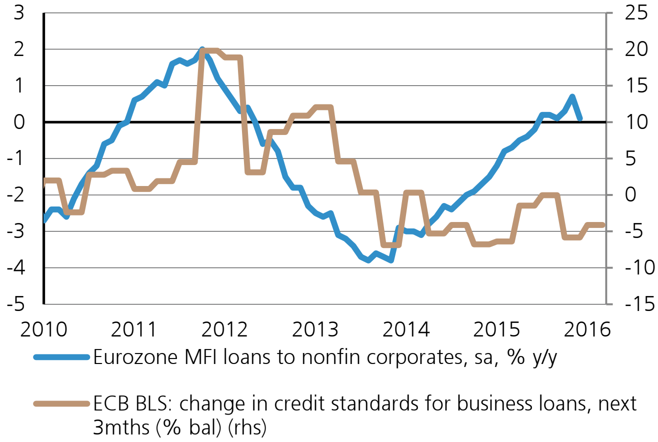
However, if the risk scenario of much deeper problems in the European banking sector were to materialize, increased risk aversion and rising financing costs for corporates – and in particular banks – would lead banks to tighten credit standards, with adverse effects on investment and growth. Such a mechanism was at play during the 2008/09 crisis and at the height of the Euro crisis in 2011/12: bond spreads rose sharply and banks began tightening their credit standards soon after (Figure 2). With some delay, credit growth started declining (Figure 3).

Figure 2: Credit standards and bond spreads



Source: Datastream, Haver, UBS.

Figure 3: Credit standards and loan growth



Source: Haver, UBS.

It is true that aggregate bank bond spreads have recently increased, but so far by much less than in these prior instances. Nevertheless, we see a risk that credit standards in Q1 might tighten somewhat, which could adversely affect the Eurozone growth outlook. However, we regard the risk of a new credit crunch as extremely low.[1]

Overall, it seems to us that the markets' pronounced pessimism, compared with our more constructive views, is probably explained by a more pessimistic assessment of the financial sector, driven by either worse future earnings growth or poorer solvency than our house view assumes.

Is the ECB running out of effective tools?

Thirteen months after the ECB kicked off its QE programme, a more sober view of the ECB's ability to lift the economy and markets now prevails. That new significant shocks have occurred in the meantime, such as a collapse in oil prices and a more significant slowdown in China/EM, is often brushed aside. In addition, there is growing awareness of the constraints that negative deposit rates have put on banks' profitability, at a time when the ECB has hinted that deposit rates might once again be cut on 10 March (from -0.3% currently); in fact, the lower bound for deposit rates does not seem to be clearly defined at the moment. We believe the ECB might have to consider introducing a tiered deposit rate, in order to limit the impact on banks.

There is also growing awareness that the EU's new banking resolution mechanism raises uncertainty for senior debt holders. It reduces the scope for public bailouts and widens the scope for private-sector bail-ins, but recent experience suggests that it can be subject to difficult political constraints and trade-offs which can slow down the resolution process.

The good news is that, unlike at the peak of the crisis, the money markets have not been impaired – if they were, the ECB would have to react quickly with a new LTRO facility. It is also good news that sovereign spreads, which set a floor under

[1] Our banks team argued: "Unless global recession and widespread deflation is really in our future, we expect our top picks to recover their lost market caps as fears around earning power and, for some banks, solvency, recede. Stable, if low, growth, and underlying profitability should see firms service their debt and pay good dividends.", Napier/Jevremovic, p. 8

corporate and bank bonds, are much lower than during the crisis, thanks to the ECB's QE programme. We would also add that the EU's crisis-fighting infrastructure is generally much more advanced than a few years ago.

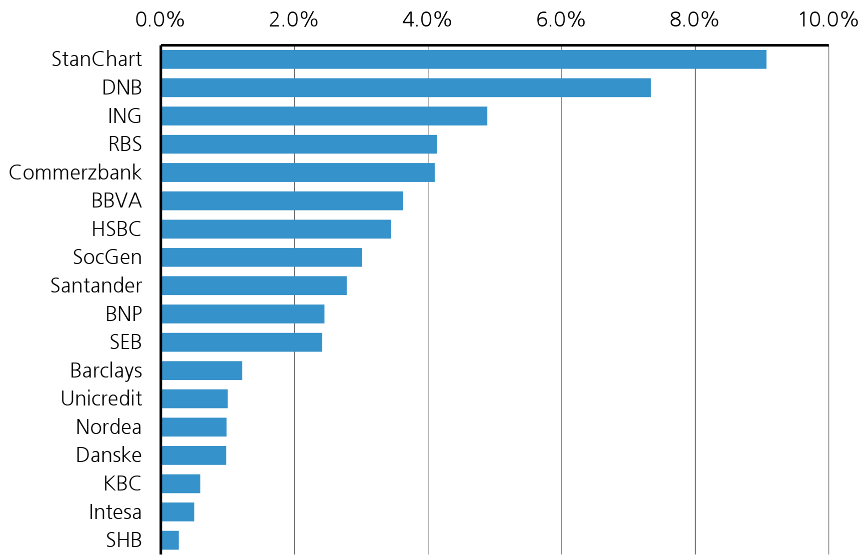
However, the rise in yields of financial sector bonds is a warning signal. And in this respect, the markets are once again struggling with the perception that the ECB remains a fairly conservative central bank. So far, the ECB has shied away from purchasing corporate bonds (and bank bonds) owing to concerns about credit risk, which is seen as higher than in the case of sovereign bonds. If the ECB were to change its stance on 10 March (presumably against the opposition of the hawks on the Governing Council) and widen its asset purchases to include corporate bonds and bank bonds, that could be a significant step – for the markets, and for the ECB itself. The ECB has not yet run out of options.

What to watch out for in the coming weeks:

- 22 February: PMIs – watch out for spillovers from US and China to Eurozone manufacturing PMIs, as well as for spillovers from Eurozone manufacturing PMIs into services PMIs;
- 23 February: German Ifo Index;
- 29 February: Euro Area HICP flash estimate for February
- 10 March: ECB meeting, with new macro projections, including for 2018;
- 19 April: ECB Bank Lending Survey for Q1 2016 – watch for a potential tightening in credit standards.

ANNEX

Figure 4: Energy-related lending exposure as a % of total, by bank (latest reported). Average in sample comes to c3%



Source: Company reports, UBS estimates

Valuation Method and Risk Statement

Risks include macroeconomic variables (such as GDP growth rates and inflation), economic slowdown, a weakening currency, global economic events, and government policy changes.

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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 31 December 2015.
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BNP Paribas[2, 4, 5, 6, 7]	BNPP.PA	Not Rated	N/A	€41.77	17 Feb 2016
BRD Groupe Societe Generale SA[7, 22]	ROBRD.BX	Not Rated	N/A	Leu9.80000	17 Feb 2016
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Danske Bank[2, 4, 5, 7]	DANSKE.CO	Neutral	N/A	DKr189.90	17 Feb 2016
Deutsche Bank[2, 4, 5, 7, 16b]	DBKGn.DE	Neutral	N/A	€16.18	17 Feb 2016
Handelsbanken[2, 4, 5, 7, 22]	SHBa.ST	Sell	N/A	SKr111.90	17 Feb 2016
HSBC[2, 4, 6, 7, 16a, 16b, 22]	HSBA.L	Buy	N/A	457p	17 Feb 2016
ING[2, 4, 5, 6, 7, 16b]	ING.AS	Buy	N/A	€10.55	17 Feb 2016
Intesa SanPaolo[2, 4, 5, 7, 13]	ISP.MI	Not Rated	N/A	€2.50	17 Feb 2016
KBC Groep NV[5, 7]	KBC.BR	Neutral	N/A	€49.70	17 Feb 2016
Nordea[2, 4, 5, 6, 7, 22]	NDA.ST	Neutral	N/A	SKr85.85	17 Feb 2016
RBS Group[2, 4, 16b]	RBS.L	Buy	N/A	257p	17 Feb 2016
Santander[2, 3, 4, 5, 7, 12, 16b]	SAN.MC	Not Rated	N/A	€3.76	17 Feb 2016
SEB	SEBF.PA	Buy	N/A	€86.02	17 Feb 2016
SEB Group[2, 4, 5, 7]	SEBa.ST	Neutral	N/A	SKr84.70	17 Feb 2016
Standard Chartered[2, 4, 5, 6, 7, 16a]	STAN.L	Neutral	N/A	446p	17 Feb 2016
Standard Chartered[2, 4, 5, 6, 7, 16a, 20]	2888.HK	Neutral (CBE)	N/A	HK$49.55	18 Feb 2016
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