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zeb/

Another endgame of the euro – Desperate banking industry losing value, trust and track in Q2 2012

zeb/market flash

Key topics

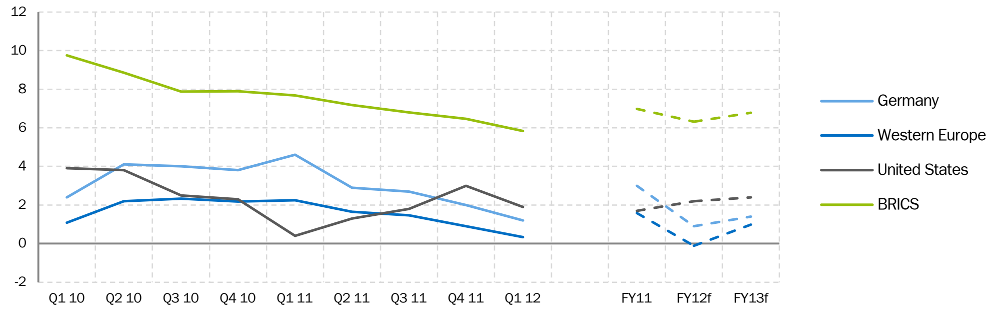
I. Global economic climate

Economic growth perspectives

The current debt and financial crisis heated up again massively in Q2 2012 and pushed GDP growth rates down all around the globe. Whereas forecasts for the US provide some positive signs for 2012/13, the outlook for Western Europe is even more pessimistic than last year. Based on the latest forecasts, the Western European economies will stagnate or even slightly decrease in 2012, which could worsen the situation for some weaker European financial institutions.

Global economic downturn in Q1 2012

Fig. 1: GDP growth and forecasts (real GDP, year-over-year growth rates, in %)

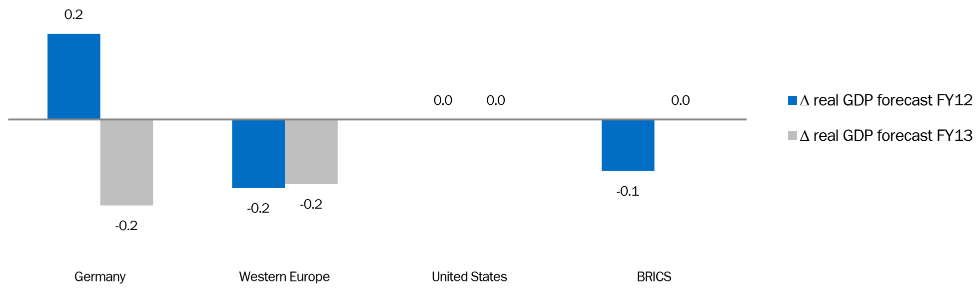


Western Europe includes the euro area, Denmark, Norway, Sweden, Switzerland, United Kingdom. BRICS: Brazil, Russia, India, China, South Africa. Full-year data shown as long-term reference figures for comparative purposes. Q2 2012 data not yet available at the time of writing.
Source: Bloomberg, zeb/research

- In Q1 2012, the economy declined on a global basis: In BRICS countries, GDP growth rates fell below 6%, in the US, the economy grew just 1.9% year-over-year, down from 3% in the first quarter – nevertheless, the outlook for both regions is stable with approx. 6% and 2% in 2012
- In Western Europe, the already difficult situation further worsened as GDP growth declined for the fourth quarter in a row, falling to just 0.3% in Q1 2012 – the outlook for the full year 2012 is even more pessimistic with -0.1% overall

Western European GDP outlook significantly reduced

Fig. 2: Change of GDP outlook (difference between GDP forecasts Q2 12 to Q1 12, in %p)

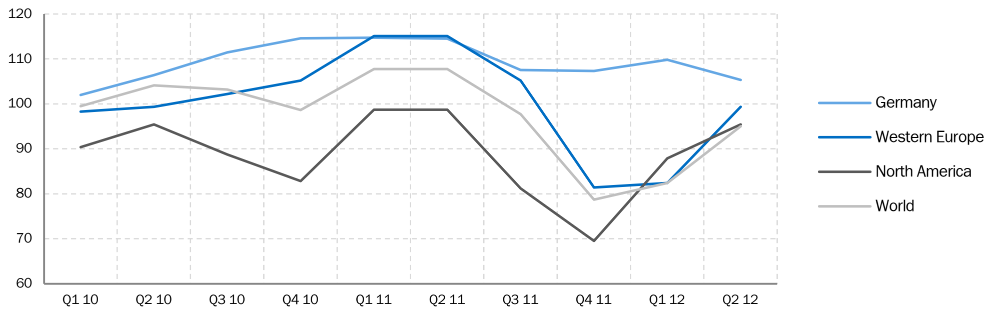


Source: Bloomberg, zeb/research

- Despite lower initial growth rates, economic forecasts for Western Europe for 2012 and 2013 were further lowered by 0.2%p during the last quarter
- In contrast, the German economy still resists the expected downturn, which is expressed in an upward adjustment of the GDP growth forecasts by 0.2%p for 2012 – however, for 2013 a downward adjustment by 0.2%p is expected

Fig. 3: Economic sentiments (ifo Business Climate Index – ifo Geschäftsklimaindex)

Sentiments more positive than current GDP growth



The ifo Business Climate Index is an indicator for economic activity based on a survey among companies on their current business situation and outlook for the upcoming six months (2005 = 100). The ifo Institute only provides data for selected countries and regions. North America includes Canada and the US, no separate data for BRICS countries available.
Source: ifo Institute for Economic Research, zeb/research

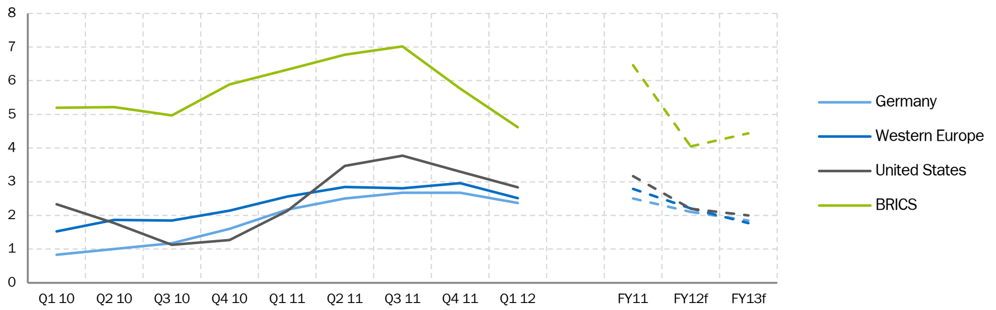
/ Despite declining growth rates, economic sentiments improved in Western Europe in Q2 2012, which may be explained by the increasing political will to address the crisis not only through rigid savings measures but also through growth-stimulating programs and the use of Eurobonds
/ Germany's business climate index, on the other hand, decreased but remained on a relatively high level, which underlines that the German economy is still stable and so far resistant to the current crisis
/ Sentiments for North America further improved in Q2 2012, indicating that the declining GDP growth in Q1 2012 (fig. 1) is rather a short-term setback than a general change of the economic recovery started in 2011

Inflation and interest rates

Global inflation rates decreased in Q1 2012, but they are still above 2% in Western Europe, Germany and the US and relatively high especially when compared to the low economic growth.

Fig. 4: Inflation rates and forecasts (annual change of average consumer prices, in %)

Inflation rates decline globally but remain on slightly elevated level

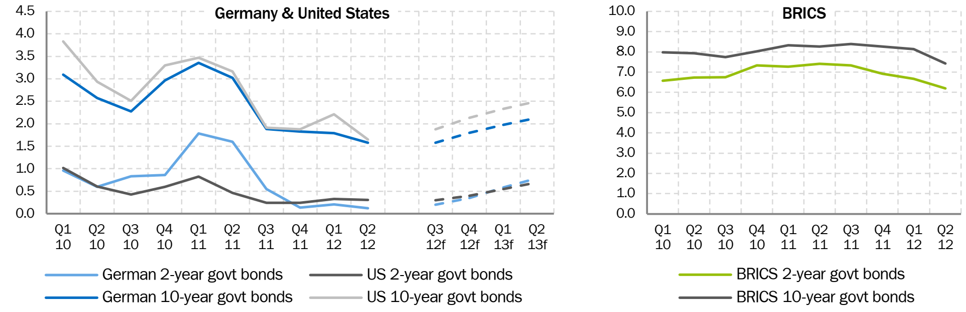


Q2 2012 data not yet available at the time of writing.
Source: Bloomberg, zeb/research

/ As discussed in our last issue of zeb/market flash, global inflation rates declined and converged in Q1 2012 due to the economic downturn

Fig. 5: Government bond yields (2/10-year bond yields p.a., in %)

Interest rates still historically low



BRICS bond yields calculated as unweighted average, no forecast data available for BRICS countries.
Source: Bloomberg, zeb/research

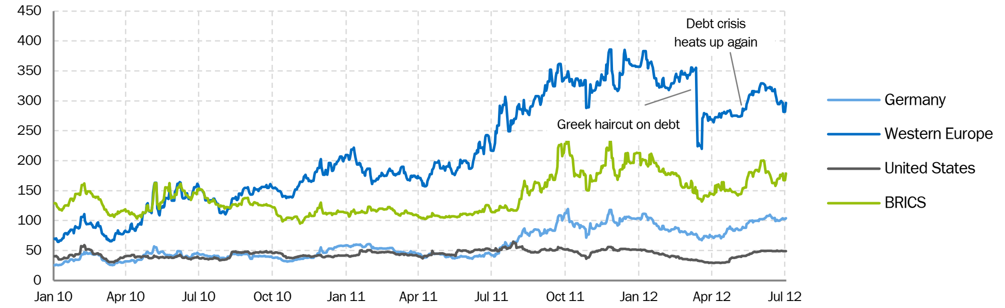
- Yields of 2-year government bonds in Germany and the US are still on historically low levels, German and US 10-year bond yields are now both below 2%
- Recent ECB decision to lower interest rate of main refinancing operations to 0.75% suggests that levels remain low for a while

Special focus: The sovereign debt crisis

In Q2 2012, the sovereign debt crisis heated up again massively. Especially Western European sovereign CDS spreads increased substantially, which proves that the Greek haircut on debt was no sustainable solution for other troubled European countries. Nevertheless, the current crisis remains a Western European crisis as US CDS spreads are still stable and nearly unaffected.

Fig. 6: Sovereign CDS spreads (5-year CDS spreads, in bp)

Greek haircut on debt brought no long-term solution



Average of Western European countries as composed by Bloomberg. BRICS 5-year sovereign CDS spreads calculated as unweighted average, no data available for India.
Source: Bloomberg, zeb/research

- The Greek haircut on debt only brought temporary relief, so that sovereign CDS spreads soon increased again – therefore the probability of further defaults remains high which could lead to further impairments and losses for banks
- Even Germany has to deal with increased sovereign CDS spreads, which reflects the risk of an additional debt burden due to the EFSF and ESM rescue funding programs
- Despite a slight increase, US sovereign spreads remain rather stable and on a relatively low level

Fig. 7: Sovereign refinancing needs (bonds and loans outstanding with maturity 2012/13, in % of nominal GDP)

High European refinancing needs decisive for the future of the Euro?

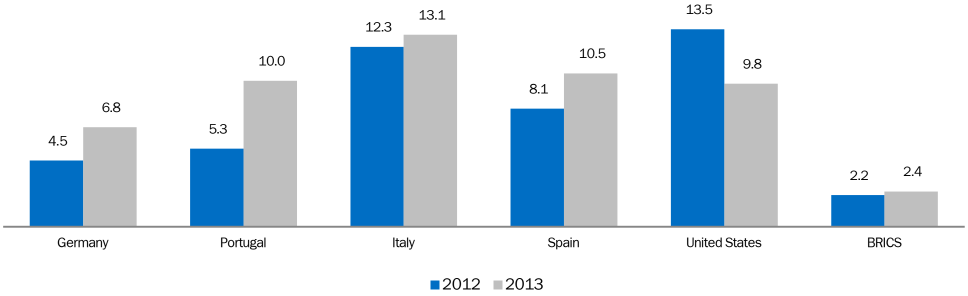


Figure contains only currently outstanding bonds and loans, without net new borrowings.
Source: Bloomberg, zeb/research

- As of June 30, 2012, especially Italy and Spain have high remaining refinancing needs, overall bonds and loans of EUR 194 bn and EUR 87 bn are still outstanding in 2012
- For Western Europe, the upcoming issuances of new Italian and Spanish bonds in the next few months will be decisive for the future path of the region and the euro

II. Key banking drivers

Selected capital market indicators

In Q2 2012, the growing uncertainty of investors affected capital markets and led to substantially higher volatilities of stock markets. In currency markets, the euro massively lost in value compared to the US dollar, indicating that investors leave the euro area in favor of more secure markets.

Fig. 8: Stock market volatilities (in bp)

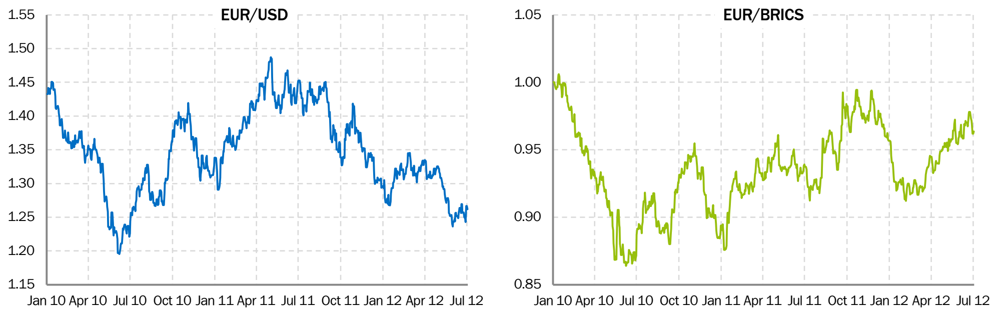
Increased uncertainty on capital markets

The BRICS volatility index is calculated as unweighted average of CBOE Brazil Volatility Index, Russian Volatility Index, India NSE Volatility Index, AlphaShares Chinese Volatility Index, JSE Securities South African Volatility Index.
Source: Bloomberg, zeb/research

- In Q2 2012, market volatilities in Europe and the US rose again with uncertainties resulting from the Greek and French elections and the Spanish banking crisis
- BRICS volatility increased, too, and reached the level of the Euro Stoxx 50 Volatility Index

Euro suffers strong depreciation

Fig. 9: FX rates (EUR/USD, EUR/BRICS basket)



EUR/BRICS basket represents a custom index of EUR/BRL, EUR/RUB, EUR/INR, EUR/CNY and EUR/ZAR exchange rates. Individual exchange rates are indexed by 1/1/2010. The basket is then calculated as an unweighted average of individual exchange rate indices.
Source: Bloomberg, zeb/research

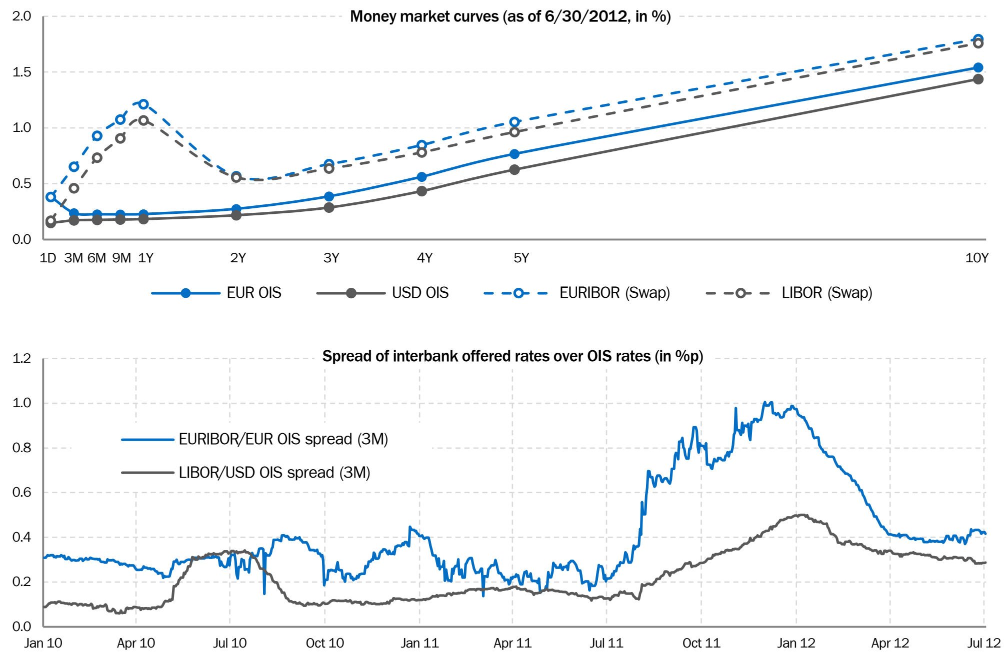
- After an interim recovery in the first months of 2012, the EUR again suffered a strong depreciation against the US dollar in Q2 2012, ending at USD 1.26 per EUR
- In contrast, the EUR/BRICS-rate increased again – overall, risk-averse investors continued to move their funds to the US, away from emerging markets and the troubled euro area

Funding costs and margins

Q2 2012 brought no further relief to the interbank funding situation. Money market curves remain very steep in the short-term perspective as the 3-month spreads remain on their previous levels. In the euro area, deposit interest rates for private and corporate customers slightly decreased, whereas loan interest rates in corporate business returned to the level of Q4 2011 again.

Interbank funding situation unchanged

Fig. 10: Interbank market rates (interbank offered rates and overnight indexed swaps)



Source: Bloomberg, zeb/research

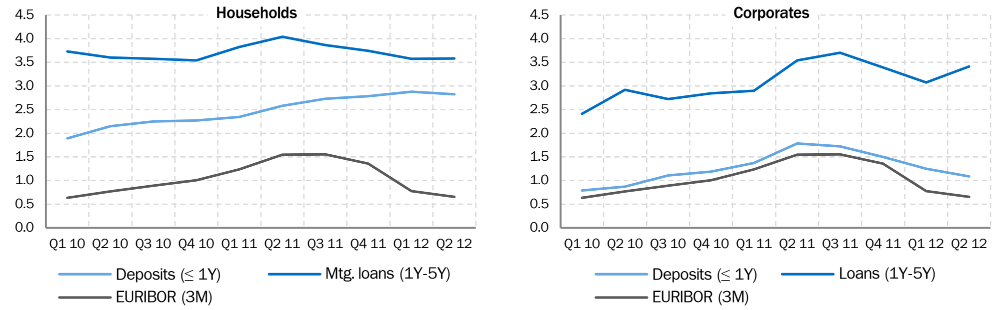
/ Compared to the previous quarter, EURIBOR rates decreased in Q2 2012, shifting the EUR swap and OIS curves downwards close to the level of their hardly affected US dollar counterparts

/ Banks still see a high probability of defaults in the interbank markets – on June 30, 2012, EURIBOR and the currently heavily discussed LIBOR curves still were unusually steep and the spreads to corresponding EUR and USD OIS curves indicate that banks still prefer interest rate swaps over interbank lending

/ The 3-month spreads did not change significantly in Q2 2012, but the spread of 0.4%p for the euro area interbank market and the USD LIBOR/USD OIS spread of 0.3%p remained well above normal levels

Fig. 11: Deposit and loan interest rates in the euro area (new business rates) and EURIBOR (in %)

Margins only improve for corporate business



Source: European Central Bank, zeb/research

/ Although deposit interest rates for households slightly decreased in conjunction with 3-month EURIBOR in Q2 2012, the competition for customer deposits as a cheap and stable funding is still high, consequently, household margins remain narrow given that mortgage loan rate remained on previous quarter's level

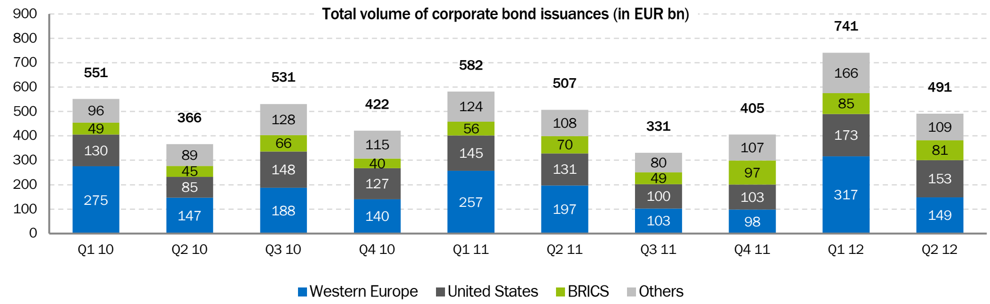
/ Corporate deposit rates further declined while loan rates went up by 0.3%p, improving the corporate loan business margins

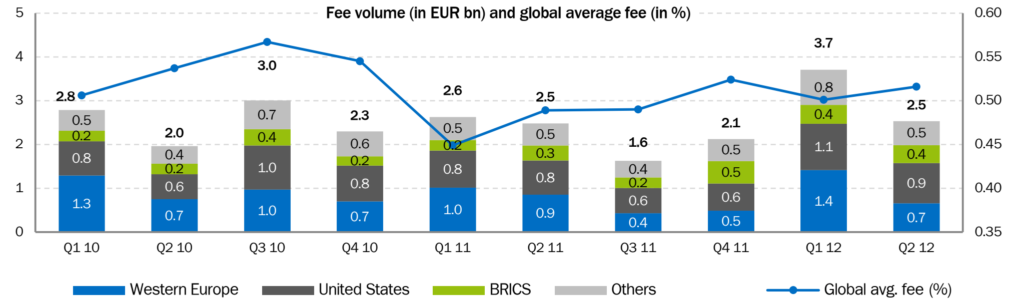
Investment banking activities

In Q2 2012, the total market volumes of corporate bond issuances and equity offerings decreased according to the typical seasonal pattern. The reduced fee volumes in both of these investment banking fields and a decreased fee level in the equity offering business led to declining investment banking earnings. Similarly, the M&A advisory business exhibited a slight decline except for the region "Other" which contains all countries other than BRICS, Western Europe and the US.

Fig. 12: Corporate bond issuance business by home region of issuing company

Seasonal reduction of bond issuances volume



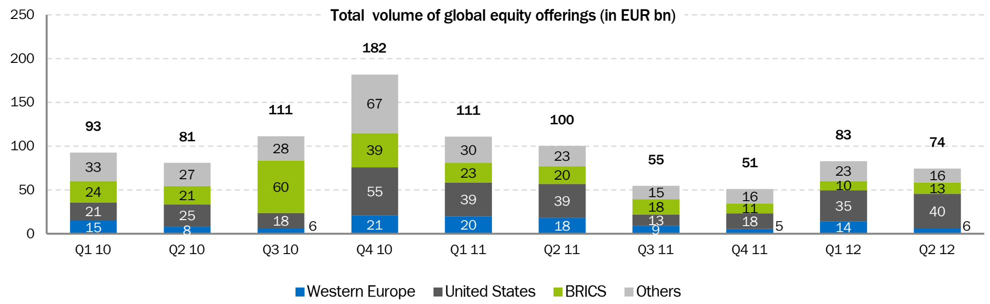


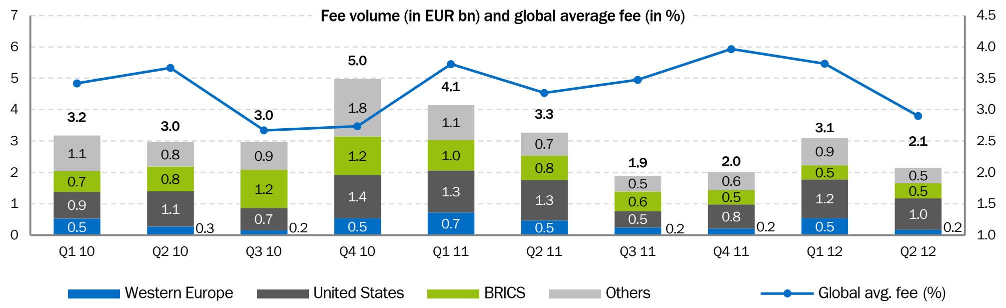
Fee volume (left-hand axis) and global average fee rate (right-hand axis) are estimated based on offering volume and volume-weighted average of all available fees.
Source: Bloomberg, zeb/research

- In Q2 2012, the global volume of corporate bond issuances shrank by 34.1% to EUR 491 bn, a level slightly below the figures of the corresponding quarter in 2011
- Especially Western European companies cut funding via corporate bonds with an issuance volume 53.1% lower than in the previous quarter – an indicator for unfavorable market conditions
- The small increase in fee rate could not offset the drop in business volume, leading to a decline in the global fee volume of EUR 1.2 bn (-31.7%) compared to previous quarter's level

Fig. 13: Equity offering business by home region of issuing company

Western European clients reduced equity offerings





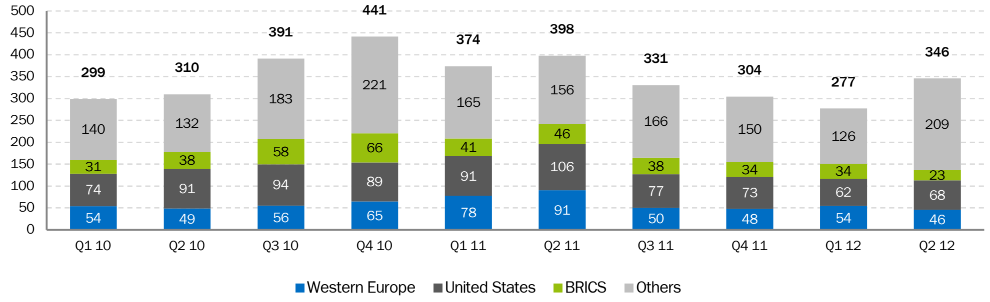
Equity offering business includes initial public offerings and additional equity listings. Fee volume (left-hand axis) and global average fee rate (right-hand axis) are estimated based on offering volume and volume-weighted average of all available fees.
Source: Bloomberg, zeb/research

- Compared to the bond issuances, global equity offering volumes declined to a lesser extent – global volume fell by 10.3% from EUR 83 bn to EUR 74 bn in Q1 2012
- Together with a 0.7%p lower average fee this resulted in a fee volume of EUR 2.1 bn (-30.5%)

/ The increased business volume in the United States is influenced by the relatively large IPO of Facebook – without this IPO the US volume would have declined, too.

Fig. 14: Deal volume of M&A business by home region of acquired company (in EUR bn)

M&A business stopped downward trend



Category "Others" includes all M&A transactions with target companies from regions different than those specified and deals with targets in multiple regions not further specified. All transactions classified by announcement date.
Source: Bloomberg, zeb/research

/ After a full year of diminishing M&A volume, Q2 2012 brought a substantial jump in volume by 24.7% to EUR 346 bn – however, the various regions developed quite differently with Western Europe and the BRICS actually declining in volume

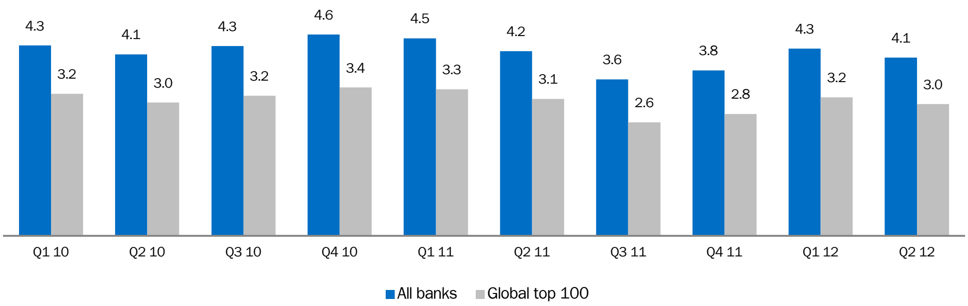
III. State of the banking industry

Market valuation

In Q2 2012, the banking sector could not continue its recent recovery. Instead, the market capitalization of the global banking sector and the 100 largest institutions decreased noticeably. This development brought no fundamental change to valuation differences among banking business models, as national commercial banks with their relatively limited regional risk profile are still valued higher than international banks or diversified banks with high shares of investment banking.

Fig. 15: Market capitalization of the banking sector (end of quarter, in EUR tr)

Banks' market valuation decreased after periods of recovery



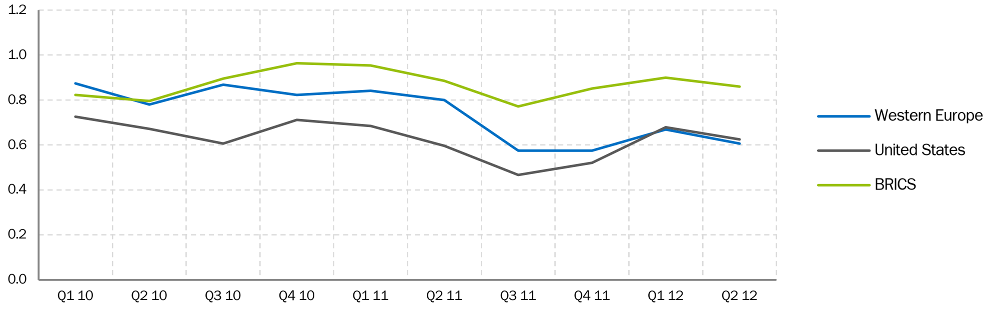
All banks include all banks worldwide according to Bloomberg classification. Global top 100 banks contain largest banks by market capitalization.
Source: Bloomberg, zeb/research

/ At the end of Q2 2012, the global banking industry has lost some of its value that it had recovered during the last three quarters

/ Both all banks and the top 100 institutions lost EUR 0.2 tr in market capitalization down to EUR 4.1 tr and EUR 3.0 tr, respectively

Western European banks' valuation declined most

Fig. 16: Market capitalization of global top 100 banks by region (in EUR tr)



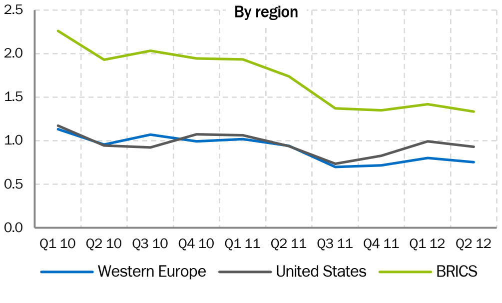
Source: Bloomberg, zeb/research

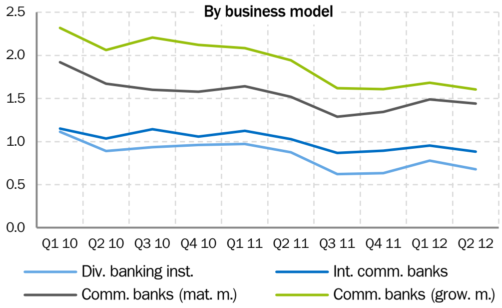
/ As the sovereign debt crisis remained unsolved and the macroeconomic outlook weakened even for emerging markets, Q2 2012 showed decreasing market capitalizations of banks all around the world

/ In Western Europe, the effect of the debt crisis is amplified by the Spanish banking crisis – as a result, the market capitalization of Western European banks among the top 100 institutions even fell below the level of US banks in Q2 2012

Regional commercial banks still achieve highest price-to-book ratios

Fig. 17: Price-to-book ratio of global top 100 banks





Diversified banking institutions generate more than 30% of their earnings from investment banking / trading / non-classic banking activities, international commercial banks generate more than 70% of their earnings from classic banking in culturally different types of international markets, commercial banks from mature/growing markets generate more than 70% of their earnings from classic banking activities in their respective market type.
Source: Bloomberg, zeb/research

/ With regard to regional distribution, the price-to-book ratio of all banks decreased almost in parallel for mature and emerging markets in Q2 2012

/ Considering the business model of the top 100 institutions, the price-to-book ratio exhibits a somewhat stronger decrease for diversified banking institutions than for other business models

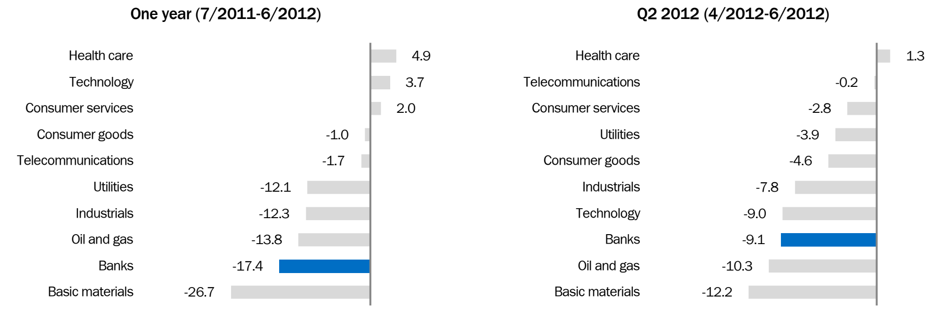
/ In spite of these developments, Q2 2012 brought no change to the general differences among price-to-book ratios of business models, as capital markets still favor national commercial banks and their stable customer deposits funding base and less volatile business

Equity performance

Across all sectors, the global equity performance was very poor in the second quarter of 2012 – the banking sector is no exception. Both on a quarterly and annual basis, the average total shareholder return (TSR) of banks is well behind other sectors. Within the banking sector, commercial banks have the best TSR performance, though in parts with negative TSRs.

Fig. 18: Total shareholder return of industry sectors worldwide (in %)

Banks among worst-performing industry sectors

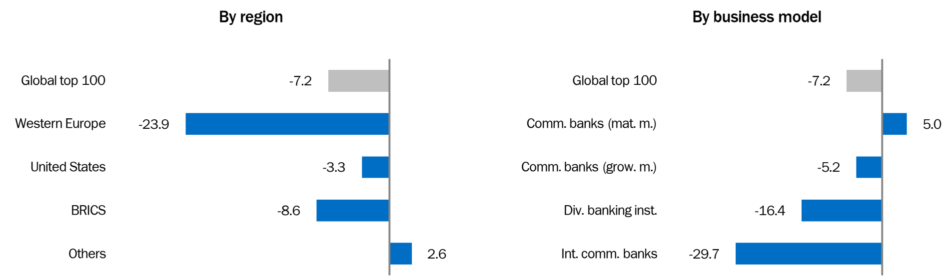


Total shareholder return of industry sectors based on global sector total return indices, aggregated and provided by Datastream.
Source: Datastream, zeb/research

/ In Q2 2012, the global macroeconomic slowdown is reflected in the TSR performance of all industry sectors – only the health care sector shows a slightly positive return
/ In addition to the general economic environment, banks were also negatively affected by the turmoil of the capital markets and the possibility of new defaults and impairments arising from the European debt crisis
/ As a result, with -9.1% the TSR of banking institutions is among the three low performers in Q2 2012, further reducing the one-year return to -17.4%

Fig. 19: Total shareholder return of global top 100 banks (7/2011-6/2012, in %)

Diversified banking institutions with worst performance



Average total shareholder returns are weighted by the market capitalization of each bank.
Source: Bloomberg, zeb/research

/ The global top 100 banks achieved a TSR of -7.2% over the last year – institutions from Western Europe and BRICS rank last (on average) among all regions with -23.9% and -8.6%, respectively
/ As seen before, international commercial banks and diversified banking institutions suffered the most from the ongoing crisis with a negative one-year TSR of -29.7% and -16.4%
/ National commercial banks with a high share of classic banking and a strong geographic focus performed best, but they, too, had a negative TSR of on average -5.2% if located in growing markets

Western European banks dominate list of low performers

Fig. 20: Top/low TSR performers among global top 100 banks (7/2011-6/2012, in %)

Global

Top performers	Country	TSR	Low performers	Country	TSR
Credicorp Ltd	Peru	48.8	UniCredit SpA	Italy	-69.0
FirstRand Ltd	South Africa	43.3	Credit Agricole SA	France	-66.5
Siam Commercial Bank PCL	Thailand	35.9	Societe Generale SA	France	-55.0
Kasikornbank PCL	Thailand	34.0	Credit Suisse Group AG	Switzerland	-45.2
US Bancorp	United States	28.9	CaixaBank	Spain	-44.9

Western Europe

Top performers	Country	TSR	Low performers	Country	TSR
Svenska Handelsbanken AB	Sweden	21.7	UniCredit SpA	Italy	-69.0
Swedbank AB	Sweden	7.3	Credit Agricole SA	France	-66.5
HSBC Holdings PLC	Britain	-4.3	Societe Generale SA	France	-55.0
Nordea Bank AB	Sweden	-9.4	Credit Suisse Group AG	Switzerland	-45.2
Skandinaviska Enskilda Banken AB	Sweden	-10.2	CaixaBank	Spain	-44.9

Source: Bloomberg, zeb/research

- As shown above, banks with the lowest TSR performance between July 2011 and June 2012 are located in Western European countries
- Banks from emerging markets dominate the global top performers ranking – only one institution from a mature market, that is US Bancorp, is among the global top five
- The list of top TSR performers in Western Europe is dominated by Swedish banks which are traditional commercial banks with a strong geographical focus on Scandinavian and Baltic markets and limited risk profile – however, even three out of five top banks had a negative TSR performance over the last twelve months

Global profitability outlook for banks revised downwards

Fig. 21: RoE after taxes and yearly RoE forecast changes of global top 100 banks (in %)

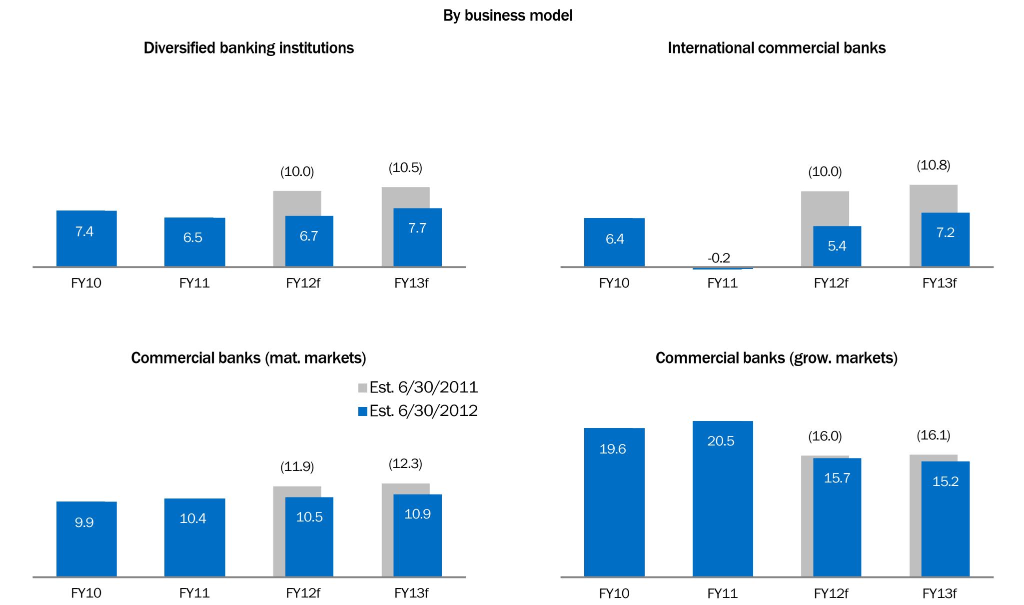


Figure compares different consensus forecasts of return on equity of global top 100 banks based on market capitalization. Forecasts are calculated as equity-weighted averages of analysts' consensus forecasts as available in Bloomberg.
Source: Bloomberg, zeb/research

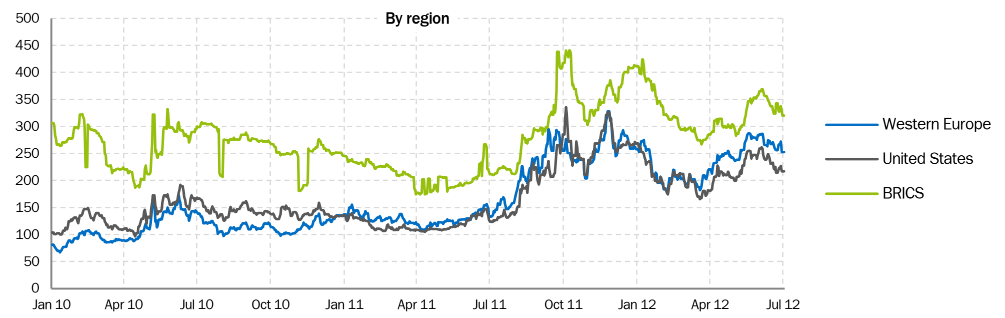
/ In general, RoE forecasts exhibit a downward trend, but substantial differences among regions and business models exist
/ In line with the observations from the TSR performances, diversified and international banking institutions received the largest downward revisions, making them the least profitable business models in expectation
/ Similarly, banks from Europe received the largest downward adjustments making them the least profitable based on current expectations, followed by US banks

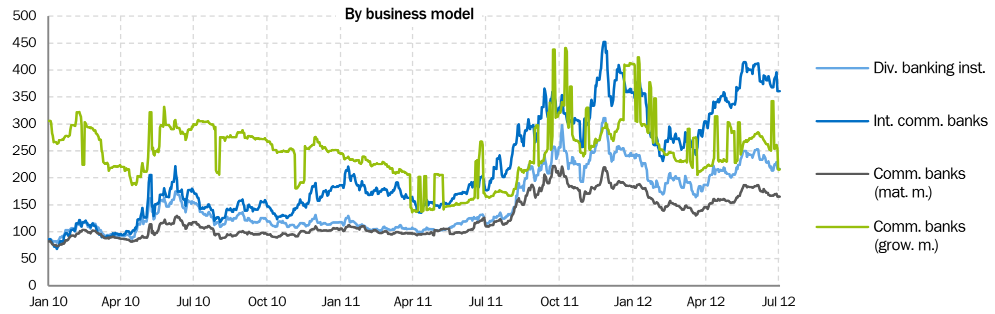
Debt perspective

The poor equity performances together with the ongoing debt crisis and the Spanish banking crisis make up a global banking sector which is far from being stable. As a result, banks' CDS spreads have worsened in Q2 2012 and the number of rating downgrades remains high.

Banks' CDS spreads rise again all around the globe

Fig. 22: CDS spreads of global top 100 banks (avg. 5-year CDS spreads, in bp)



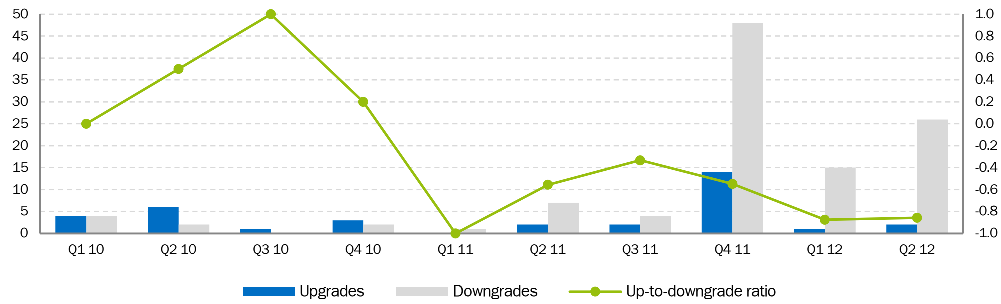


5-year CDS spreads are calculated as unweighted average of CDS spreads of each bank.
Source: Bloomberg, zeb/research

/ After a short relief in Q1 2012, CDS spreads increased for global top 100 institutions with +20.0% for Western European institutions, +14.5% for US banks and +12.2% for banks in the BRICS countries
/ The differentiation across business models within the last two years continues – international commercial banks have, by far, the highest CDS spreads with an average of 361 bp at the end of Q2 2012 and the strongest increase of 18.5% among all business models in Q2 2012

Fig. 23: Rating changes of global top 100 banks

Series of rating downgrades continues



Rating changes consider number of upward and downward revisions of long-term rating of global top 100 banks as provided by Standard & Poor's, Moody's, Fitch Ratings. Outlook revisions are excluded. Up-to-downgrade ratio (right-hand axis) is a harmonized index calculated as (number of upgrades – number of downgrades) / sum of upgrades and downgrades.
Source: Bloomberg, zeb/research

/ In Q2 2012, the sovereign debt and Spanish banking crises led to more than 25 downgrades, thus continuing the trend of massive downgrades of the last two quarters
/ Due to the large number of downgrades, the up-to-downgrade ratio remains below -0.8, which indicates that there still is a considerable uncertainty in the market about the stability and business perspective of banks
/ When considering both elevated CDS spreads und weak financial markets, the conditions for funding and capitalization of banks become even more costly and difficult – in light of the coming changes with Basel III, these funding and capitalization issues remain a key challenge for the business models of the global banking industry

About zeb/market flash

zeb/market flash is a quarterly compilation of market data putting the total shareholder return (TSR) performance of the global banking industry, economic fundamentals and key value drivers into perspective. It is published by zeb/rolfes.schierenbeck.associates. All data and calculations of this issue are based on the due date July 2, 2012.

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