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2016 with a happy ending for the banking sector—however, high market uncertainties for 2017

zeb.market.flash Q4 2016

Key topics

I. State of the banking industry

- The banking industry has been the biggest winner in the latest stock market rally. The global top 100 banks boosted their market cap (+18.2%) and outperformed all other industries (TSR of +17.2%).
- Especially US banks benefited from increasing US rates and the market trends due to the election of Donald Trump.

II. Economic environment and key banking drivers

- Upward movements of global long-term yields as well as the latest Fed decision led to steeper EURIBOR and USD LIBOR yield curves.
- The US Dollar was further strengthened by the result of the US election and increasing US interest rates—EUR/USD exchange rate has reached the lowest value for more than 10 years.
- European and BRICS banks' RoE shrank on average by 0.6pp to 5.7% and 0.5pp to 15.4% respectively—US banks further improved their profitability by 0.5pp to 8.9%.

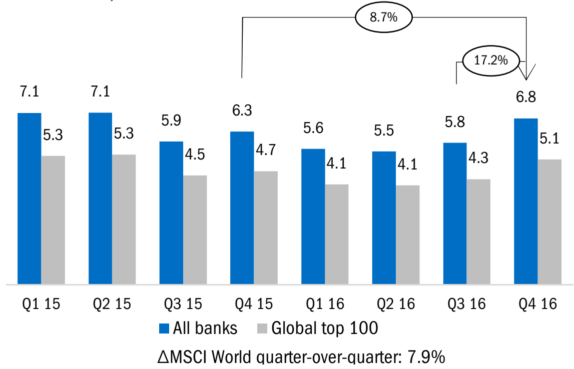
III. Special topic: Trumpflation—"Make interest rates great again"?

- High expectations towards Donald Trump's political agenda led to a sharp increase in global long-term government bond yields.
- Concrete economic consequences are not clear yet and a sustainable spillover to Europe is rather doubtful—European banks still have to deal with low interest rates and high market uncertainties in 2017.

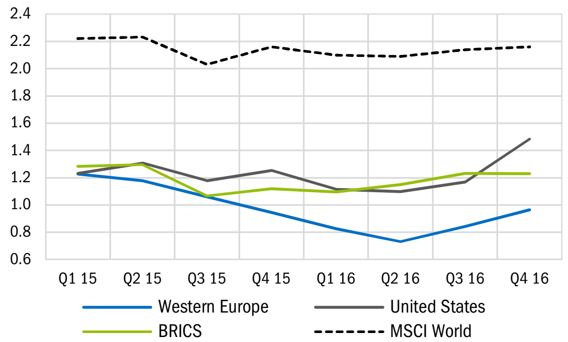
I. State of the banking industry

The banking industry has been the biggest winner in the latest stock market rally. In the final quarter of 2016, the global top 100 increased the market cap by 18.2% (all banks: +17.2%) and outperformed all other industries with a TSR of +17.2%. Especially US banks benefited from increasing US rates and expectations concerning less US banking regulation in the upcoming years as part of Donald Trump's political agenda.

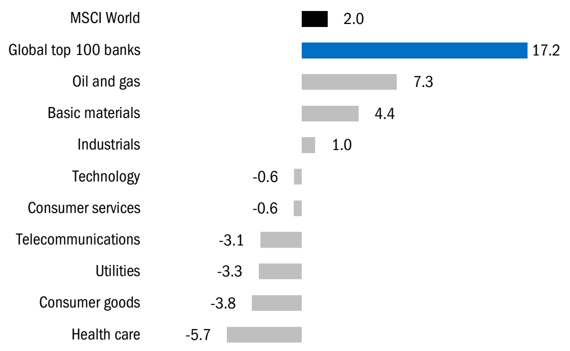
Market capitalization of the banking sector (end of quarter, in EUR trillion)[1]



Price-to-book ratio of global top 100 banks and MSCI World[2]



TSR of industry sectors worldwide (10/2016–12/2016, in %)[3]



Top/lowest TSR performance among global top 100 banks (10/2016–12/2016, in %)

Top performers	Country	TSR
SOC GENERALE SA	France	51.9
GOLDMAN SACHS GP	United States	48.9
DEUTSCHE BANK	Germany	47.4
CITIZENS FINANCIAL	United States	44.8
MITSUBISHI UFJ F	Japan	42.6

Low performers	Country	TSR
AXIS BANK LTD	India	-16.9
ALLIED IRISH BANK	Ireland	-16.7
KOTAK MAHINDRA	India	-7.4
HDFC BANK LTD	India	-5.2
BANKCOMM-H	China	-5.1

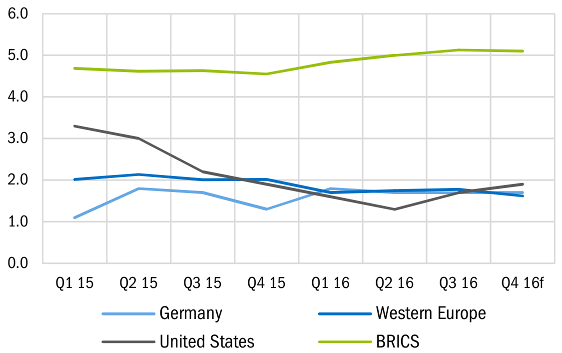
1) All banks worldwide according to Bloomberg classification. Global top 100 banks contain largest banks by market capitalization on December 31, 2015. Figures are aggregated in EUR, without adjustments for foreign currency effects; 2) Western Europe: euro area, Denmark, Norway, Sweden, Switzerland, UK. BRICS: Brazil, Russia, India, China, South Africa; 3) Total shareholder return (TSR) of industry sectors other than banking based on global sector total return indices, aggregated and provided by Thomson Reuters Datastream. Average total shareholder returns of global top 100 banks are weighted by the market capitalization of each bank; Source: Bloomberg, Thomson Reuters Datastream, zeb.research

- Exuberant stock markets led to increasing overall market capitalization (MSCI World +7.9% qoq). Especially the capitalization of all banks reached EUR 6.8 tr (+17.2%) achieving the largest value since Q2 2015. The market cap of the global top 100 even jumped up by 18.2% to EUR 5.1 tr.
- In Q4, the global top 100 banks showed, by far, the largest TSR performance among all industries (+17.2%). Overall, the banking sector completed 2016 with a TSR of 15.6% (US +24.6%, BRICS +12.9%, Europe +7.7%).
- For the second time in a row, US as well as European banks showed increasing P/B ratios. European banks finished 2016 with an average P/B ratio aiming at the 1.0x and US banks with 1.5x.
- Above all, due to higher US rates and increasing expectations concerning a change in banking regulation under Trump, TSR of US banks increased by 22.7% since the US election (Western Europe +11.4%, BRICS -0.8%).
- Among the top performing banks, Deutsche Bank may surprise: the market was relieved by the settlement with US in mortgage cases, which encouraged the banks' recovery from large losses over the last quarters. However, yoy Deutsche Bank still lost 23.6%.

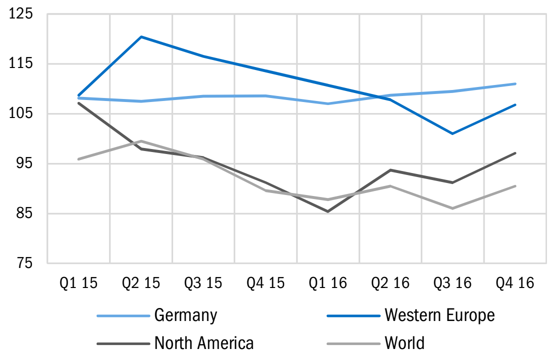
II. Economic environment and key banking drivers

The economic climate brightened again for all major regions in the third quarter of 2016, however, in Q4 only the US shows a forecasted increase of GDP growth rates. Upward movements of long-term yields as well as the latest Fed decision led to a steeper EURIBOR and USD LIBOR yield curve. In Q4, the EUR/USD exchange rate reached the lowest value for more than 10 years, whereas the EUR stabilized against the British pound.

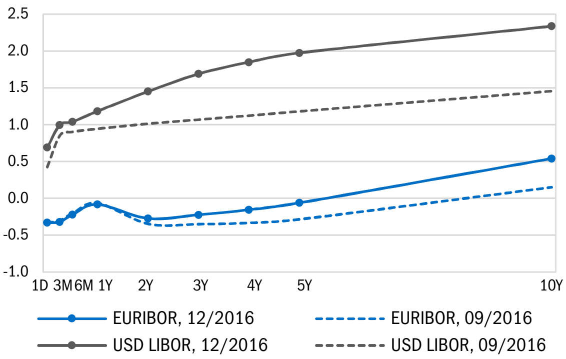
GDP growth and forecasts (real GDP, year-over-year growth rates, in %)[1]



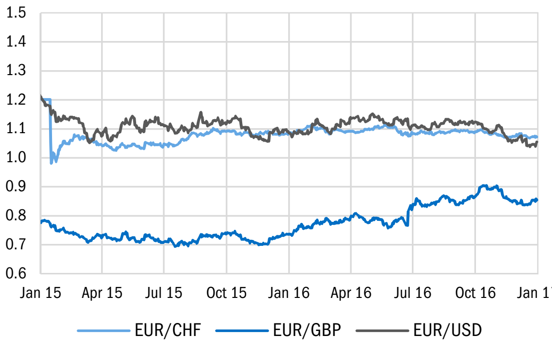
Economic sentiments (ifo Business Climate Index)[2]



Money and capital market rates



FX rates (EUR/CHF, EUR/GBP, EUR/USD)

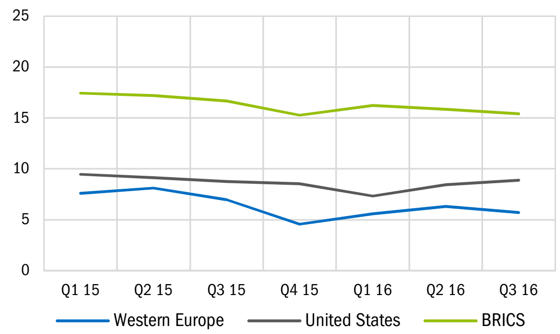


1) Western Europe: euro area, Denmark, Norway, Sweden, Switzerland, UK. BRICS: Brazil, Russia, India, China, South Africa; Q4 16 based on forecasts; 2) The ifo Business Climate Index is an indicator for economic activity based on a survey among companies on their current business situation and outlook 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: Bloomberg, ifo Institute for Economic Research, Thomson Reuters Datastream, zeb.research

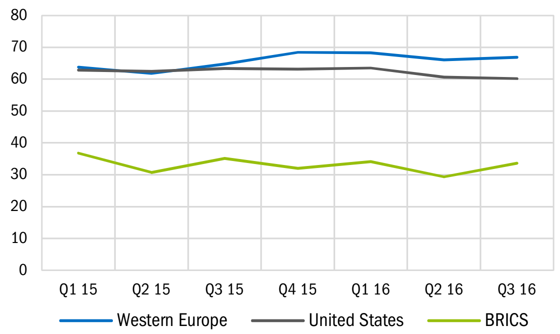
- Following the forecasts, the US is expected to be the only region with increasing GDP growth rates in Q4 (+0.2pp), whereas the growth rates of Germany, Western Europe and BRICS countries don't show any significant changes.
- However, the economic sentiments brightened again for all major regions due to improved economic expectations in the US and Europe. In particular, the economic sentiment for Western Europe climbed up despite persistent uncertainty due to the Brexit, the Italian referendum and possible effects as result of the US election.
- According to a strong upward movement of long-term yields during Q4, the long end of the EURIBOR and USD LIBOR curve raised sharply. Furthermore, as a result of the latest Fed decision to raise interest rates by 25 bp, the USD LIBOR curve shifted slightly upward.
- The US Dollar was further strengthened by the US election result and increasing US interest rates. At the end of Q4, the EUR/USD exchange rate reached the lowest value for more than 10 years (yoy the EUR lost 3% compared to the USD). Although the British pound could make up for some losses at the beginning of Q4, the EUR/GBP FX rate increased by 16% year over year.

In Q3 2016, US banks could further improve their profitability, whereas European banks fell further behind. The gap between European and US banks' CIR also continued to widen. Although interest rates on corporate loans slightly increased, other customer interest rates in the euro area continued their downward trend.

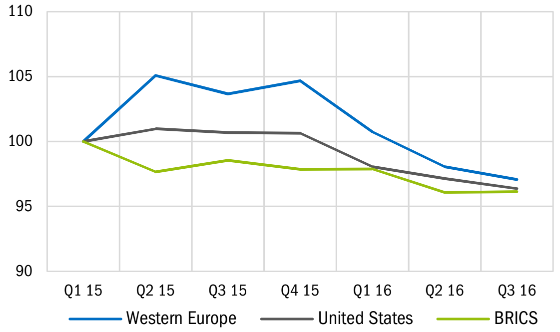
RoE after tax of global top 100 banks (in %)[1)]



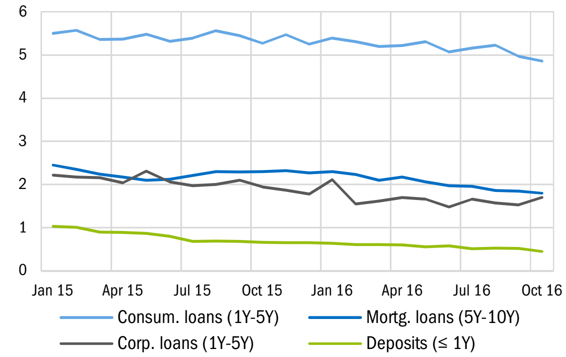
Cost-income ratio of global top 100 banks (in %)[2)]



RWA density development of global top 100 banks (in %)[3)]



Customer interest rates in the euro area (new business, in %)



Q4 16 data not yet available; 1) Post-tax RoE (return on equity): post-tax profit to average total equity; 2) Cost-income ratio: operating expenses to total income; 3) RWA density: risk-weighted assets (RWA) to total assets; RWA density indexed to 100 on March 31, 2015; Source: Bankscope, ECB, zeb.research

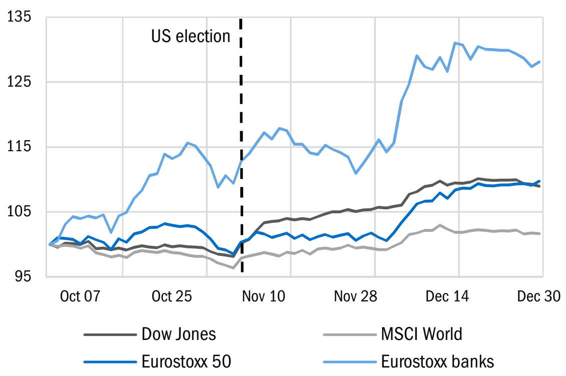
- European banks' RoE on average shrank by 0.6pp to just 5.7%. Almost 70% of the European banks were not able to improve their profitability, but rather reduced it. Obviously, the strong capital market performance during the last quarter is lacking a fundamental basis.
- After a negative trend until the beginning of 2016, US banks could further improve their profitability in the third quarter 2016. The average post-tax RoE was 8.9% and again close to the level of the beginning of 2015. BRICS banks' profitability decreased for the second time in a row, but remains far above those of US and European banks.
- In Q3, the gap between European and US banks' CIR continued to widen. BRICS banks' CIR increased by 4.3pp, but is still below the value of Q1 2016.
- The convergence of the RWA densities of the global top 100 banks still continued in the third quarter.
- Over the third quarter, corporate loans rates increased by 0.05pp. Apart from this, customer interest rates in the euro area continued to decline. The latest ECB decisions to leave interest rates unchanged as well as to extend the QE program until December 2017 makes a turnaround in the near future rather unlikely.

III. Special topic

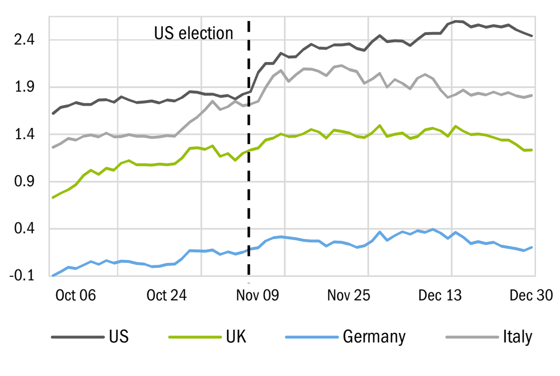
Trumpflation—“Make interest rates great again”?

Global capital market reactions clearly defied analysts’ expectations when Donald Trump was elected the next US president. Instead of a huge market turmoil, capital markets showed a surprisingly positive reaction. Especially interest rates shooted up after the election indicating the belief that Trump could “make interest rates great again” in the US as well as Europe.

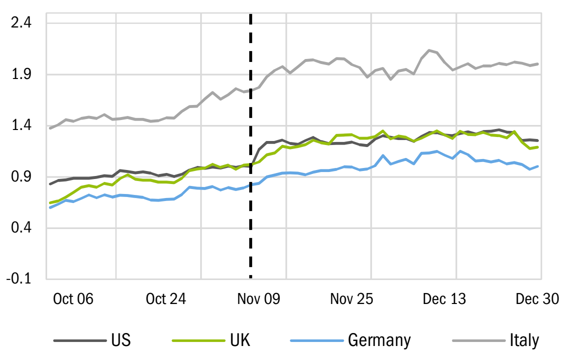
Stock market indices (indexed to 100)



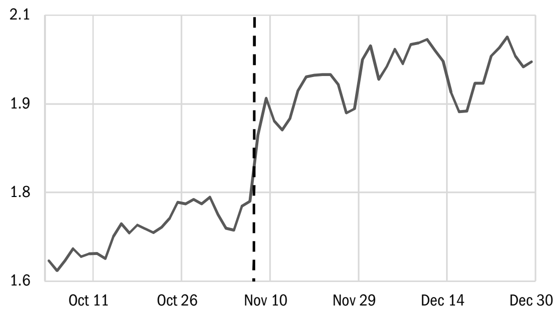
Long-term government bond yields (10 years, in %)[1)]



Government bond yield spreads (10-2 years, in %)



US 10-year breakeven inflation rate (in %)[2)]



1) Average yields of 10-year government bonds; 2) Calculated by subtracting the real yield of the inflation-linked maturity curve from the yield of the closest nominal Treasury maturity. The implied inflation rate results for the term of the stated maturity. The latest value implies what market participants expect inflation to be like in the next 10 years, on average; Source: Bloomberg, zeb.research

After a brief shock moment, stock markets around the world picked up. Especially, the innocuous acceptance speech of Donald Trump led to more optimism in the global capital markets. Since the US election, the Dow Jones Index increased by 8.2%, the Eurostoxx 50 by 8.8% and the MSCI by 3.5%; Eurostoxx banks increased by 12.5%. However, one market is seriously affected—global bond markets declined strongly as yields jumped up. Long-term government bond yields showed strong upward movements whereby US yields skyrocketed, but also international long-term rates increased significantly. In the first week after the US election, 10-year US government bond yields climbed by 36bp and also European yields showed a corresponding increase (UK +14bp, Germany +12bp and Italy +24bp). As a result, yield curves became clearly steeper. The corresponding spreads between 10-year and 2-year bond yields increased for the US by 23bp, for the UK by 16bp, for Germany by 12bp and for Italy by 17bp.

These developments on the bond markets can be mostly explained by the election of Donald Trump and his political agenda: tax cuts across the board (especially for corporates and high-income earners), extra public spending on infrastructure and trade protectionism. Tax cuts in line with a huge economic stimulus package will further increase the US government budget deficit, which therefore has to be financed by a higher emission of government bonds. Furthermore, as there is already nearly full employment in the US and capacity shortages, economic stimulus will lead to higher prices in general. In fact, with Trump's election, market inflation expectations jumped up by 17.5bp in just two days, which simultaneously raised the hope that the Fed will return their policy to more normal levels. These expectations concerning a higher budget deficit, higher inflation and increasing short-term rates are drivers of higher US bond yields. The current transmission to European and other global bond yields is based on market expectations about positive spillover effects.

So did Trump "make interest rates great again" and what are potential consequences for Europe and the European banking sector? Of course, the "Trump effects" already influenced the latest Fed decision on December 14 and a slightly increasing interest rate level in the US over 2017 is fixed. The Fed raised US rates by 25 bp and Janet Yellen announced three further hikes for 2017. In addition to current stable US figures, Trump's political agenda left room to raise US rates in order to prevent an overheated US economy. A sustainable spillover to Europe is, however, rather unlikely. Affected by the latest ECB decision on December 8, the European bond markets were calming down in recent weeks. Related to the full year of 2016, current European yields and spreads are not that high and, especially in Germany and the UK, rather the result of a market trend since mid 2016. Year over year, the yields on UK and German government bond yields are far below the value at the beginning of 2016 (UK -72bp, Germany -43bp) and spreads between 10-year and 2-year bond yields slightly increased for Germany by just 3bp and even decreased for the UK by 12bp.

The current developments in the US put additional pressure on the ECB and their current monetary policy. The widening gap between the US and the European low yield environment will lead to capital outflows from Europe. Furthermore, protectionist measures by the new US government could prevent Europe to benefit from a fiscal boost of the US economy. The "trap" of low economic growth, capital outflows and the pressure to increase interest rates can lead to new problems for the EU economy. With higher expected interest rates in the future, there are rising concerns about the resilience of the weaker EU economies (especially in Italy due to political uncertainties). Therefore, without an appropriate economic development on the European continent, the ECB would rather take measures to avoid a spillover of higher rates from the US.

Accordingly, it is still too early to hope for an end of the historically low interest rate environment in Europe—and to discard the low interest rate scenarios in planning. Compared to the US banking industry, European banks will fall further behind.

Trump's economic program is expected to boost growth in the US at least temporarily. However, it is not clear how much of Trump's agenda will be implemented and the concrete economic consequences are also not known yet. In the euro zone, the ECB will likely maintain its accommodative policy due to fundamentally unchanged growth and inflation as well as persisting structural problems.[1] Overall, Trump's election increases existing speculation and uncertainties in the market caused by the Brexit and the consequences of the Italian referendum. European banks still have to deal with low interest rates, higher market uncertainties and higher volatilities in 2017.

[1] See also the BankingHub article "Und die Hoffnung stirbt zuletzt" (currently only available in German; available on www.bankinghub.de).

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. All data and calculations of this issue are based on the date of January 2, 2017. The global top 100 banks cluster contains the largest banks by market capitalization on December 31, 2015 and is updated on an annual basis. Data is subject to ongoing quality assessment. As a consequence, minor adjustments could be applied to historical data as well as forecasts shown in previous issues of zeb.market.flash.

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