Srinivas Thiruvadanthai
Director of Research

*Based on an article in the January 2014 *Levy Forecast*.

Unrealistic Expectations for European Financial Stocks

- ***Underweight European financial stocks***
- ***Short European financial stocks against long U.S. financial stocks***

European financial sector stocks have surged 97% from the low in June 2012, handily outperforming the overall European market (chart 1). Many observers expect financial stocks to continue their run as they see the sector benefiting disproportionately from an economic recovery. Clearly, the financial sector has been the major beneficiary of the ECB's extraordinary and successful efforts at stabilizing the eurozone economy and the financial system. However, the prospects for the financial sector look less rosy, at least relative to other sectors in Europe and to U.S. financials. European bank earnings are likely to be weighed down by several factors and banks' balance sheet health remains precarious and vulnerable to negative revelations. Moreover, the overall European recovery remains fragile and susceptible to adverse developments.

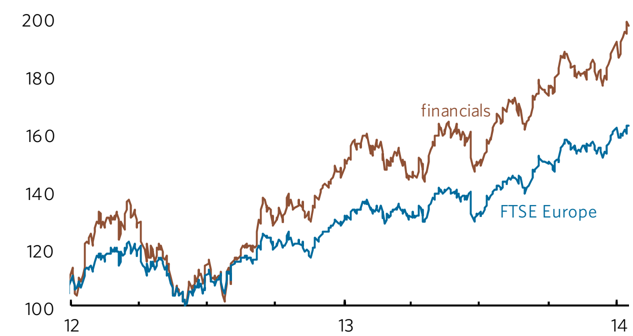
In some ways the experience of the European financial sector over the past 18 months resembles the experience of the U.S. financial sector in the immediate aftermath of the 2008-2009 financial crisis. In the United States, unprecedented intervention by the Federal Reserve and the Treasury averted a collapse and stabilized the financial system and the economy. As a result, financial sector stocks, which had fared the worst, experienced a massive rally and hugely outperformed the overall stock market from March 2009 to April 2010 (chart 2). Similarly, in Europe, the ECB's extraordinary measures—LTRO and Draghi's "whatever it takes" stance—helped prevent a disaster; naturally, the financial sector was the biggest beneficiary.

However, 2014 is likely to be more difficult for European financial stocks as earnings face challenges from many sources. First, continued private sector deleveraging, which has a long way to go, will thwart recovery in European financial sector profitability, just as it hampered the U.S. financial sector during 2010-2011 (chart 3). Bank lending to the private nonfinancial sector in Europe has been coming down relentlessly since 2011 (chart 4), which has hurt net interest income. This trend is likely to continue as the private nonfinancial sector remains heavily indebted and there has been little progress in bringing the debt-to-GDP ratio down (chart 5).

European Financials' Recent Outperformance CHART 1

FTSE Europe Index, MSCI Europe Financials Index

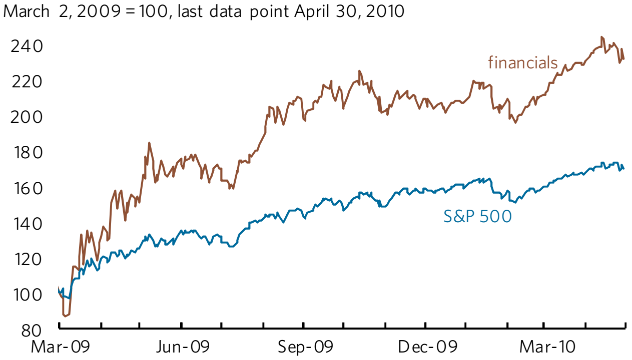
June 1, 2012 = 100, last data point January 16, 2014



U.S. Financials Outperformed from 2009 to 2010 CHART 2

S&P 500 Index, U.S. Financial Sector ETF

March 2, 2009 = 100, last data point April 30, 2010



Second, net interest income of European banks is also likely to suffer from the decline in interest rates on periphery sovereign debt. European banks have been benefiting from the large spreads on periphery sovereign debt even as the banks enjoyed lower interest costs thanks to the cheap funds from LTRO, but interest rates on periphery sovereign debt have been declining rapidly (chart 6).

Third, loan loss provisions are likely to remain high. Nonperforming loans are high and rising in the periphery (chart 7), and European banks, relative to their U.S. counterparts in 2009-2010, have been less active in provisioning for bad loans.

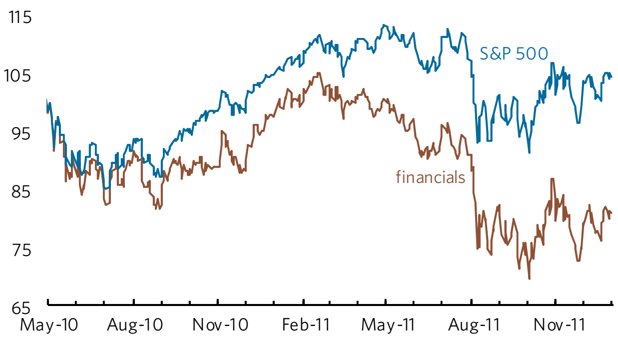
Fourth, European banks remain heavily undercapitalized (chart 8), and efforts to address the problem will dilute earnings. Over the course of 2014, banks are likely to face some urgency in raising capital as the ECB is likely to insist that many banks improve their capital position before the ECB assumes full responsibility for the banking system toward the end of the year. Banks are also likely to keep shedding assets in order to alleviate capital shortfalls, which will entail recognizing losses and losing income. In comparison to the rest of the world, the European banking system is much bigger in relation to its economy (chart 9) and will have to shrink substantially in the coming years.

In addition, the ECB's comprehensive assessment has the potential to create turmoil for banks. If the ECB is strict, causing a revelation of a substantial capital shortfall that overwhelms the fiscal capacity of an individual sovereign, it will most probably trigger turmoil in the financial markets. On the other hand, if the ECB attempts to water down the review, leading to findings with more benign implications, the market reaction might not be entirely positive. Keen euro area watchers are aware of the balance sheet weaknesses in the regions' banks and have rough estimates of the capital shortfalls. Attempts to paper over problems may well be poorly received by the markets. Furthermore, the ECB will be

Underperformance From 2010 to 2011 CHART 3

S&P 500 Index, U.S. Financial Sector ETF

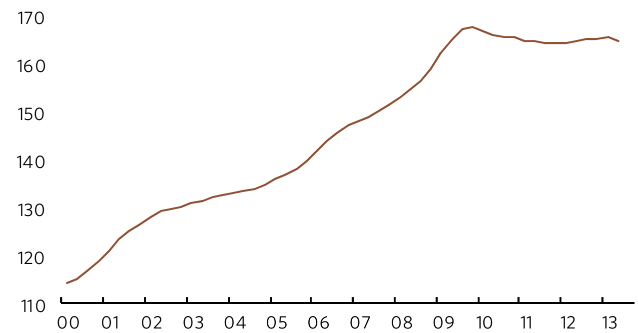
May 3, 2010 = 100, last data point December 30, 2011



No Correction in Euro Area Private Sector Debt CHART 5

Household plus Nonfinancial Business Credit Market Debt as % of GDP

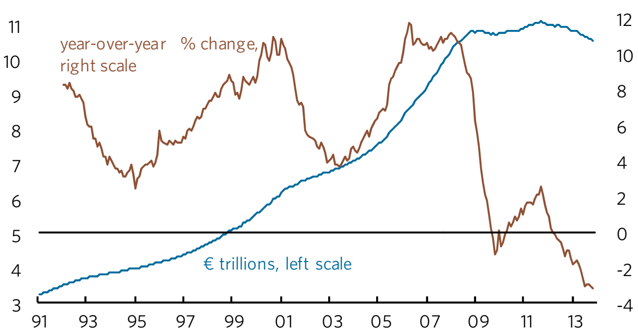
4-quarter moving average, last data point Q2 2013



Bank Lending Declining CHART 4

ECB: Euro Area Bank Lending to Private Nonfinancial Sectors

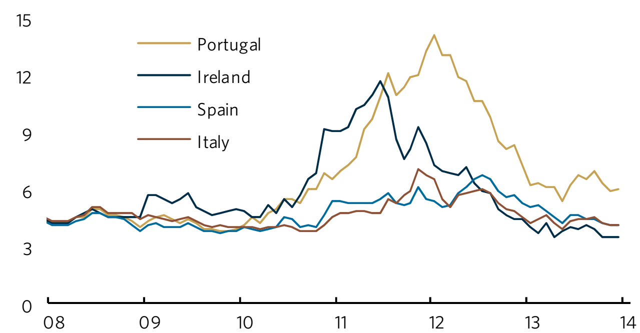
seasonally adjusted, last data point November 2013



Sovereign Yields in the Periphery CHART 6

Yields on 10-Year Government Securities

% per annum, monthly averages, last data point December 2013



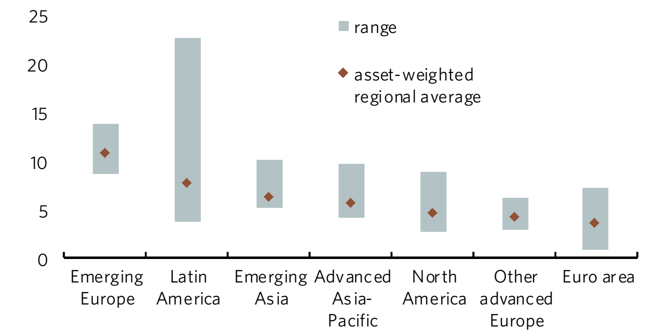
wary of taking actions that dent its credibility and raise questions about the long-term financial stability of the euro area. After all, the current European financial stability has been purchased by the ECB's taking on a growing role without an explicit legal and political backing for its actions.

Finally, the eurozone recovery remains shaky. A widening current account surplus, which has come on the back of emerging markets, has been the key profit source behind the ending of the recession in the euro area. With EMs weakening, Europe's ability to maintain its current account surplus is questionable. Domestic private profit sources may pick up for a few quarters, perhaps a year, but probably not much longer. Although austerity has waned, there is no great desire to expand deficits actively. Thus, the recovery will at best remain anemic and vulnerable to adverse shocks, especially EM weakness.

In the near term, European financial stocks may well continue their strong performance, especially given the money pouring into European equities and the widespread optimism about Europe among fund managers. However, the trend is unlikely to last as the year progresses. Investors with a longer time horizon should lessen their exposure to the European financial sector. For those with more flexibility, a short position in European financial stocks against long positions in the U.S. financial sector is likely to be rewarding over the next 6 to 12 months. While we have plenty of questions about U.S. financial stocks, there is no question that they are in much better shape than European banks.

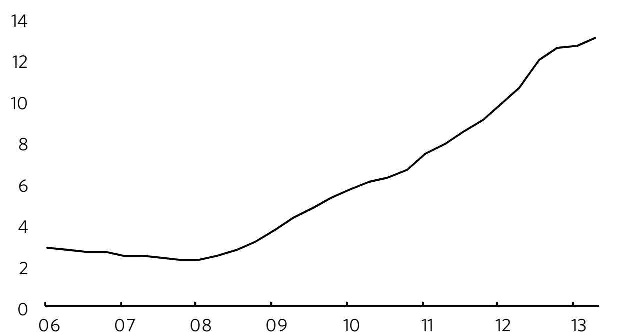
Eurozone Banks Heavily Leveraged CHART 8

IMF: Large Banks' Adjusted Tangible Equity as % of Adj. Tangible Assets in Q4 2012



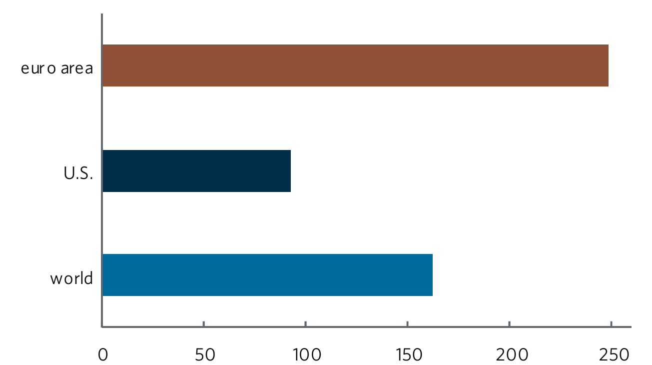
Periphery Nonperforming Loans CHART 7

IMF: Nonperforming Corporate Loans as % of Loan Book in Portugal, Spain, and Italy, Q2 2013 average of April and May



Euro Area Banks Large Relative to Economy CHART 9

IMF: Bank Assets as % of GDP, 2012



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Contact Douglas Williams: DWilliams@levyforecast.com (914) 666-0641