

A dovish ECB, a little relief for the banking sector



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- **The European Central Bank (ECB) announced a new series of TLTROs starting in September 2019 and changed its forward guidance, with a commitment not to hike rates this year.**
- **Eurozone economy:** The ECB revised down its forecasts for inflation and GDP growth in 2019/2020, signalling that risks remain tilted to the downside. Since December, the economic outlook has significantly deteriorated. We remain of the view that domestic demand (and in particular household consumption) will continue to be supported by a strong labour market performance, strong income growth and the level of monetary policy accommodation. Subsequently, we believe that **growth will gradually reaccelerate by the end of this year**. However, core inflation is expected to remain significantly below the 2% target and risks remain skewed to the downside, especially in the short run. This fully justifies the dovish stance adopted by the ECB.
- **The fixed income view:** This next TLTRO was already factored in to some extent by bondholders and investors in the euro currency. An additional impact could be expected depending on how large and/or cheap it turns out to be. In the optimum scenario, it should benefit the peripheral banks, specifically Italian banks.
- **The equity view: TLTRO III is expected to reduce the risks of a funding cliff and economic contraction for the weaker southern European banks by ensuring that they have access to liquidity on cheap terms, and thereby prevent any unnecessary deleveraging and credit contraction. However, the terms announced are less helpful than initially expected, and less generous than the last scheme. This measure may give only partial relief to the banking sector, where valuations are depressed, and significant risk remains, especially on the economic front.**
- **From a bottom-up perspective, we are cautious on European investment banks as we believe the business model is structurally challenged.** We therefore prefer banks with predominantly retail operations, which are in a better position to make better risk-adjusted returns on capital. Given the uncertain outlook, with risks potentially coming from the economic cycle or new litigation risks (e.g., money laundering), we believe investors should give preference to banks with strong solvency levels and the ability to generate high levels of capital internally.

What is your assessment of the Eurozone economy and your reading of the ECB's revision of growth and inflation?

Since December, the economic outlook for the euro area has significantly deteriorated. Despite a recovery that started well after that of the US, Eurozone (EZ) economies began to slow in H2 2018, much more sharply than other economies. Several transitory factors have contributed to the slowdown in EZ growth. For instance, Germany was close to falling into recession in Q4 due to an abrupt slowdown in world trade, disruptions in the auto sector caused by new pollution tests and the weakness of the global manufacturing sector. The outlook in Italy has also massively deteriorated, mainly for domestic reasons. We believe the shock on the EZ manufacturing sector at the end of 2018 has been underestimated by most economists, including ECB staff.

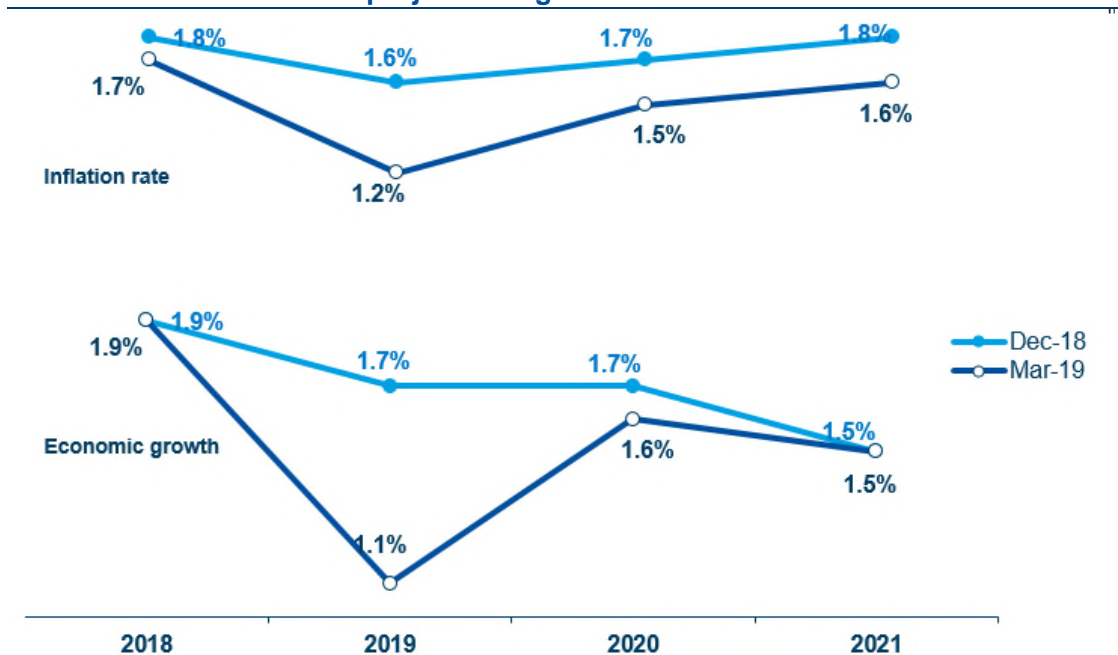
Along with most economists, we have revised down our GDP growth forecasts for the Eurozone over the past six months and **we now expect 1.2%/1.5% growth in 2019/2020**. The OECD released on 6 March its interim outlook and is somewhat more pessimistic than we are with 1.0%/1.2% growth expected for 2019/2020. Unsurprisingly, the ECB also revised down its GDP growth forecasts from 1.7%/1.7% for 2019/2020 to 1.1%/1.6%, close to our

“We expect 1.2%/1.5% growth in 2019/2020, but in the short run risks remain tilted to the downside.”

own forecasts (1.2%/1.5%). The outlook for core inflation has also been substantially lowered from 1.4%/1.6% to 1.2%/1.4%, substantially below the 2% target. Even in 2021, the core inflation forecast was revised down from 1.8% to 1.6%. This change is very significant and explains the very dovish stance adopted by the ECB. As a matter of fact, inflation models have failed over the past years to correctly predict the inflation path. The ECB now recognises that inflation will stay below its target for longer than previously anticipated.

Regarding economic activity, **recent data point to still weak growth in Q1, but the most recent purchasing managers' indices indicate a stabilisation in the services sector**, which is more sensitive to domestic demand than to global trade.

ECB staff macroeconomic projections: growth and inflation revised down



Source: ECB, as of March 7 2019.

We remain of the view that domestic demand (and in particular household consumption) will continue to be supported by a strong labour market performance, strong income growth and the level of monetary policy accommodation. **We believe that growth will gradually reaccelerate by the end of this year.** But, in the short term, uncertainty is likely to remain high (Brexit, European elections, global trade). Against this backdrop, risks to growth remain skewed to the downside. The ECB basically has the same base scenario as the growth profile retained by the ECB is indeed close to our scenario – the important point being that even if GDP growth reaccelerates the ECB intends to wait before acting.

How the ECB's policy is expected to evolve?

Given the uncertain environment, the ECB has kept its assessment on risks unchanged (i.e., tilted to the downside) and, in addition, has announced a new series of quarterly TLTROs starting in September 2019 and ending in March 2021. TLTRO III will have a two-year maturity rather than the four-year maturity for TLTRO-II, which was announced in March 2016 and began in June 2016.

According to the ECB: *“These new operations will help to preserve favourable bank lending conditions and the smooth transmission of monetary policy. Under TLTRO III, counterparties will be entitled to borrow up to 30% of the stock of eligible loans as at 28 February 2019 at a rate indexed to the interest rate on the main refinancing operations over the life of each*

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operation. Like the outstanding TLTRO programme, TLTRO III will feature built-in incentives for credit conditions to remain favourable.”

These new loans will implicitly be at a **floating rate tied to the main refinancing operation, currently set at zero, meaning that this rate may evolve over the period.** This is a key difference between the TLTRO II mechanisms, where “counterparties exceeding the lending benchmark (could) borrow at a rate that (could) be as low as the deposit rate at the time of allotment”. The precise modalities are still to be released. **This decision should alleviate the burden on the banking sector,** in particular in southern Eurozone economies, especially Italy. The announcement of new TLTROs was widely expected and had to some extent been pre-announced in recent weeks. However, the modus operandi was still in question. The fact that they will start in September and not in June as had been expected is somewhat surprising, but is not a game-changer.

Regarding interest rates, the ECB has also changed its forward guidance, expecting rates, “to remain at their present levels at least through the end of 2019, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term”.

This confirms our view that the ECB has very little room for manoeuvre given the weak growth momentum, low inflation and the level of risk (Brexit, trade tensions, geopolitical risks), which remains elevated.

Interestingly, the ECB has not even left the door open to any hike, even technical, in its deposit rate in H2, which emphasises the very dovish signal that the ECB intended to send to markets today.

At the end of the day, it confirms our view that **the ECB has no room for manoeuvre to normalise its monetary policy, and is likely to keep its key rates unchanged even in 2020.**

What could be the effects of a renewed stimulus on the European fixed income market?

Market talks the talk... and the ECB does walk the walk... the rumour was right; the state of the European economy is deteriorating gradually, the headline inflation forecast is down, thus the next main measure by the ECB has been confirmed with the third TLTRO announcement. It will be aimed at encouraging commercial banks in the Eurozone to borrow at very favourable terms, confirming the ECB's role as the main gatekeeper for cash supply.

This new TLTRO was already factored in to some extent by bondholders and investors in the euro currency. **An additional impact could be expected depending on how large and/or cheap it turns out to be.** In an optimum scenario, **it should benefit the peripheral banks,** specifically Italian banks, which were the main beneficiaries of TLTRO II, and more broadly should benefit the whole credit market.

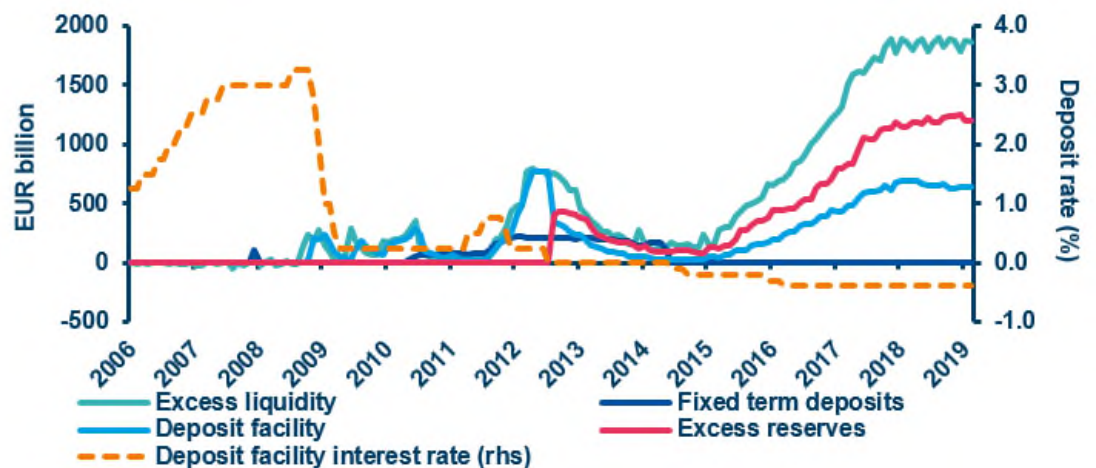
Should European economic growth show signs of a severe slowdown and/or recession later in the year, leading spreads to widen significantly, then the ECB would undoubtedly envisage a new QE by reopening its corporate sector purchase programme. This would again be supportive for credit generally but, in the interim, would also signal a more bearish trend. Our base scenario does not call for the latter yet.

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The deposit rate is expected to stay negative for the moment. What implications are there for banks' profits?

Banks' balance sheets were not designed to cope with negative deposit rates and these constrain the sector's ability to cover its cost of capital as it is difficult for Eurozone banks to pass this cost onto retail customers. At present, there is more than €1.8 trillion of excess liquidity with the ECB at -40bps, which costs the banking industry about €7bn per annum. However, more broadly, negative deposit rates serve to keep market interest rates low. While the authorities have highlighted the benefit to the sector of a low rate environment, namely via improved asset quality and low default levels coupled with gains from bond holdings, which have boosted solvency ratios, it has taken a large toll on revenues and hurt profitability. In 2018, the banking sector deeply underperformed the overall European index and weighed on the relative performance of European equities vs. major developed markets indices.

Euro bank excess of liquidity and deposit rate



Source: Bloomberg, as of March 7 2019.

What does a new TLTRO mean for European banks? Which regions/types of banks could benefit the most?

The new TLTRO III reduces the risks of a funding cliff for the weaker European banks by ensuring that they have access to liquidity on relatively cheap terms, thereby preventing any forced deleveraging and credit contraction. However, the terms announced today are less helpful than initially expected, with a shorter duration and a higher cost, and are less generous than the last scheme, TLTRO II. However, further details on the pricing structure of TLTRO III should be provided at the April ECB meeting, with potential for “incentives” to be offered to banks to help credit conditions. Overall, we think that the tighter conditions of the new scheme will limit the banks’ capacity to supplement revenues through “carry trades” by purchasing sovereign bonds to bolster earnings. This is likely to impact the take-up of the new TLTRO III facility, with many of the stronger core European banks potentially unlikely to roll over the majority of their existing TLTRO facilities.

Where do you see opportunities in the European financial sector?

The sector experienced a significant de-rating last year, mainly due to political and macro factors that adversely affected investor sentiment. For example, the correlation of Italian banks and BTP sovereign holdings tends to increase in times of political stress, and weighed on the wider banking sector.

In addition, new money laundering scandals for the Nordic banks dented confidence in the space given the increasing litigation risks. Political factors will remain in the spotlight in the coming weeks, but more benign conditions for the sector could potentially materialise after the European elections and in case of a Brexit deal. **If economic conditions do not deteriorate materially, we could see the banking sector bottoming out from its very depressed levels.**

However, a strong focus on bottom-up selection will be needed, as risks are still significant (economic deceleration/political). That said, we believe that attractive valuations may represent an opportunity to add exposure to fundamentally undervalued banks with high quality balance sheets that are capable of providing decent profitability and returns on equity. From a bottom-up perspective, we are cautious on European investment banks as we believe the business model is structurally challenged. We therefore prefer banks with predominantly retail operations, which are in a better position to make better risk-adjusted returns on capital. Given the uncertain outlook, with headwinds potentially coming from the economic cycle or new litigation risks (e.g., money laundering), we prefer to be invested in banks with strong solvency levels and the ability to generate high levels of capital internally.

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Definitions

- **Beta:** Beta measures an investment's sensitivity (volatility) to market movements in relation to an index. A beta of 1 indicates that the security's price has moved with the market. A beta of less than 1 means that the security has been less volatile than the market. A beta of greater than 1 indicates that the security's price has been more volatile than the market.
- **Correlation:** The degree to which assets or asset class prices have moved in relation to one another. Correlation ranges from -1 (always moving in opposite directions) through 0 (absolutely independent) to 1 (always move together).
- **TLTRO:** The targeted longer-term refinancing operations (TLTROs) are Eurosystem operations that provide financing to credit institutions for a predefined period of time.

Important Information

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Diversification does not guarantee a profit or protect against a loss.

Correlation: The degree of association between two or more variables; in finance, it is the degree to which assets or asset class prices have moved in relation to each other. Correlation is expressed by a correlation coefficient that ranges from -1 (always move in opposite direction) through 0 (absolutely independent) to 1 (always move in the same direction).

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