Weekly Flash

Brexit talks are reaching their final stage

MARKET PERFORMANCES (as of December 11, 2020 – 15:15 CET)

	CURRENT	CHANGE 1 WEEK	CHANGE YTD		CURRENT	CHANGE 1 WEEK	CHANGE YTD
S&P 500 Index	3'668.10	0.04%	13.54%	Gold	1'839.85	0.09%	21.29%
S&P/Toronto Stock	17'593.34	0.41%	3.11%	Silver	23.99	-0.74%	34.67%
EuroStoxx 50	3'489.47	-1.41%	-6.83%	Oil WTI	46.65	0.84%	-23.60%
SMI Index	10'395.67	0.30%	-2.08%	EUR/USD	1.2126	0.07%	8.19%
DAX Index	13'126.98	-1.29%	-0.92%	EUR/CHF	1.0782	0.23%	0.66%
Nikkei Index	26'652.52	-0.37%	12.66%	USD/CHF	0.8891	0.29%	-8.51%
Emerging Market Index	69'776.93	0.18%	13.52%	USD/JPY	104.04	0.08%	-4.32%
Yield 10Y US Treasuries	0.890	-0.0769	-102.86	CAD/USD	0.7829	-0.12%	-1.70%
Yield 10Y German Bund	-0.636	-0.0858	-44.57	USD/CNY	6.5462	-0.25%	-6.35%

[Source: Bloomberg]

Summary

- The ECB's persistent negative-yield policy undermines the profitability of the European banking sector and triggers an increasing appetite for riskier loans.
- With the Brexit drama most likely coming to an end soon, odds are high that no agreement will be reached, and U.K. has to leave the European customs union without a new trade agreement in place.

Bleak outlook for European banks

According to a recent report, published by the European Banking Authority (EBA), European banks have significantly increased their exposure to riskier lending, such as commercial real estate and loans to smaller businesses. This increased appetite for riskier loans is primarily driven by the desperate search for yield in a persistent low-interest rate environment. Looking forward, banks plan to keep increasing this easing of credit standards, which could potentially be counterproductive under stress scenarios and challenge the stability of the banking sector. The profitability of European banks is particularly affected by negative interest rates. As a result, the average return-on-equity (ROE) of the 22 banks included in the Euro STOXX Banks Index is as low as 3.8% based on consensus estimates for the next 12 months. Given the unsatisfactory profitability, it may not come as a surprise that the average price-to-book ratio of Eurozone banks is as low as 0.5%, which means that market participants are not willing to pay more than half of net assets for Eurozone banks. Unfortunately this situation will not change as long as the European Central Bank (ECB) continues its negative-yield policy, which we do not expect to be changed anytime soon. In a challenging economic environment with negative interest rates and strong competition from challenger banks, the reduction of the cost base is one of the few possibilities to improve profitability. In the U.S., where deposit rates are close to zero but not negative, the situation in the banking sector is still better. Based on consensus estimates for the next 12 months the average ROE of the 18 members of the S&P 500 Banks Industry Group Index is 8.1% and the average price-to-book ratio is above 1, more than double the Eurozone average.

No breakthrough regarding Brexit

Wednesday's talks over dinner between Prime Minister Johnson and European Commission President von der Leyen ended without a breakthrough. Despite major differences between U.K. and the EU over what their future trade relationship should look like, negotiations will continue until Sunday, December 13. The three biggest obstacles to a deal are disagreements over fishing rights, the governance of a deal and fair competition rules for businesses. If no agreement is reached, decades of free movement of goods, services, people and capital would come to an abrupt end, when U.K. leaves the EU's customs union on December 31. U.K. businesses would face tariffs, finance firms would lose their passport to offer services across the EU and people lose their rights to live and work in the EU. About 43% of British exports go to the EU and 51% of imports come from the EU each year. Starting the 1st of January 2021, British firms would revert to trading with the EU based on rules established by the World Trade Organization (WTO) in 1995. Imports from and exports to the EU would be subject to tariffs, which are 3% on average but can reach 10% in case of auto exports and 35% for dairy products. According to the British Retail Consortium, 85% of foods imported from the EU would face tariffs of 5% or more. Without a trade deal, the U.K. economy would likely suffer a shock of around 1.5% of GDP according to Bloomberg economics. The British Office for Budget Responsibility even forecasts a decline of 2% of GDP. The impact of a no-deal Brexit on the Eurozone economy would be much less severe, but still relevant. According to the International Monetary Fund (IMF) a no-deal Brexit would reduce the EU's long-term output potential by almost 0.5%.

Conclusion

A healthy, profitable banking sector willing and capable to lend responsively is a prerequisite for a growing economy. Persistently negative interest rates in the EU undermine the profitability of the banking sector and provoke higher risk taking in order to overcome the challenges. Negative deposit rates are de facto an additional tax on savings and represent nothing more than an expropriation of investors as money is shifted to debtors and government entities. The current monetary policy regime of the ECB negatively affects the free

formation of capital market prices and leads to distortions, which will likely have a long-lasting negative impact not only on the banking sector but also on the overall economy.