LPL RESEARCH
WEEKLY
ECONOMIC
COMMENTARY

August 8 2016

EUROPEAN BANKS: NEITHER A BORROWER NOR LENDER BE

Matthew Peterson *Chief Wealth Strategist, LPL Financial*

KEY TAKEAWAYS

Banks everywhere are under pressure from the low interest rate environment.

Corporate financing in Europe goes through banks, not the capital markets, making banks more important to the system.

Monetary policy in Europe has just begun to increase bank lending, which historically has resulted in higher stock prices for banks, though the full impact of negative interest rates is difficult to determine.

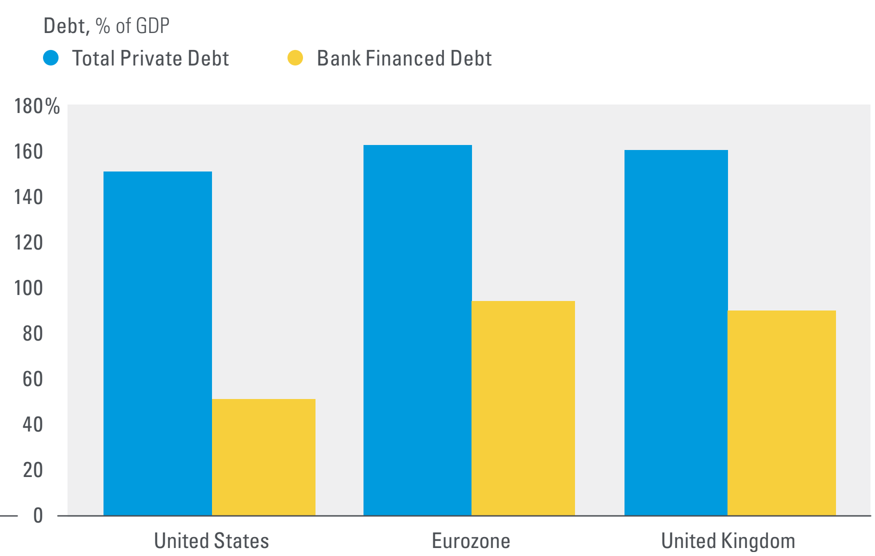
European banks are vital to economic recovery in Europe; low and negative interest policies in Europe not only hurt banks, but may be counterproductive to boosting the economy. Banks in Europe are more structurally important to the economy for a number of historical and structural reasons. The European Central Bank's (ECB) expansion of money supply and low to negative interest rate policy were designed to aid the economy. But the negative impact on banks has limited lending, therefore countering this state policy. Banks have belatedly begun to increase lending. Stock prices for European banks tend to rise with increases of lending, though historically it takes some time (approximately a year) for stock prices to begin to follow actual loans.

WHY DO RATES MATTER?

We have taken our title from Shakespeare's *Hamlet*, in which Polonius, a pompous and self-serving advisor to the king, provides a series of life lessons to his son. "Neither a borrower nor lender be" is one of the most famous.

The three regions have the same amount of private debt, but finance it differently.

1 SAME DEBT, DIFFERENT SOURCE



Source: LPL Research, Bank for International Settlement (BIS) 08/07/16

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, and is usually calculated on an annual basis.

Of course, Polonius is informing his son that borrowing and lending put the parties at odds with each other, working against both parties intentions. The ECB appears to have failed to heed this lesson. It has engaged in a number of measures to spur the economy by encouraging borrowing and spending. In particular, interest rates have been reduced to zero, and in an increasing number of cases have been negative. The ECB has also been purchasing bonds from banks at a record rate through its quantitative easing (QE) program. The idea behind these policies is that by reducing interest rates, corporations will increase their borrowing for investment and consumers will use low rates to borrow and spend.

However, the low rates have failed to do much to stimulate the economy, and may even be worsening the malaise. One reason may be the negative impact these policies have on banks. Low interest rates dampen bank profits; the bank simply doesn't make much money on the loans. This can result in a tightening of lending standards, as banks do not feel they can be adequately rewarded for taking on additional risk. Low interest rates also may lead savers to not use banks; they may withdraw their principal from the banks, as they don't earn enough on their savings to meet their spending needs. Low rates encourage savers to look elsewhere, maybe even out of the country, seeking higher rates. By depriving banks of this source of funds, the ECB is partially negating its own policy.

In today's environment, Polonius's words can be seen as a warning to the financial industry. Go ahead, try to borrow and lend, but you aren't going to make any money at it. But it's also a warning to the ECB: be careful of the unintended consequences of your actions.

WHY DO BANKS MATTER?

Banks and bank lending are much more important to the European economy than they are in the U.S. In Europe, approximately 80% of all corporate debt is in the form of a bank loan, with only 20% structured as a bond. In the U.S., those figures are approximately reversed. The differences in the regions are even more striking when looking at sources of credit as a percentage of gross domestic product (GDP) [Figure 1]. The U.S., the Eurozone, and the U.K. all have very similar private sector debt-to-GDP ratios. However, the European nations, including the U.K., which is counted differently as it does not use the euro, are more reliant on banks to fund the economy. This tendency is somewhat surprising for the U.K., which typically follows the more dynamic Anglo-Saxon model of capitalism, relying on the capital markets—the issuance of stocks and bonds, and the trading of loans through the securitization of debt—to finance corporate activity.

When we look down to the capital structure, to high-yield bond issuance, levered loans, and securitization of debt, the difference between Europe and the U.S. grows even starker. By some estimates, European issuance of high-yield debt is only 35% of that of the U.S. when adjusted for GDP. The securitization market is only 17% of that of the U.S., adjusted the same way. Relative to the U.S., not only do European banks create a disproportionate amount of the credit, they tend to keep the loans on their books. This does not allow banks to diversify these risks. It also may mean that if a bank is overleveraged, or has too much bad debt, it may reduce lending to good creditors, which hinders economic growth.

Both the causes and effects of the dominance of traditional banking, rather than use of the capital markets, are impacting the health of European banks. There are many reasons why Europe is so dependent on banks. Among them is the fact that, outside of the largest of banks, transnational banking is itself a relatively new concept, boosted by the EU and its common currency. Even banks based in countries that do not use the euro, such as the U.K. and Switzerland, benefit from the fact that so many other countries are using the euro, as it reduces the number of currencies used. European banking evolved in an era where each country had one or two "national champion" banks and a few smaller banks that typically operated in just one region or province.

Further explaining the importance of banks to Europe are the higher savings rates relative to the U.S. [Figure 2]. Different countries have different savings rates, even within Europe. Polonius also warns that "borrowing dulls the edge of husbandry"—the management of resources, primarily land and livestock in Shakespeare's day. Judging from the economic health of many of the highly indebted countries, maybe they should have heeded the warning.

IMPACT OF POLICY

People tend to believe that central banks worked in a coordinated way after the financial crisis of 2008 to support global growth. In fact, the ECB was late to the party. Though it kept rates low, European money supply was stagnant in 2010 and rose slowly after that. It has only been since 2014 that the ECB has aggressively expanded the money supply [Figure 3]. Bank lending actually declined in 2009, and after a brief increase, was negative on an annualized basis for almost three years. It has only been recently, since the beginning of this year, that bank lending began to increase. This increase, should it continue, will be evidence that European economic recovery is truly underway. Given the reliance on banks for financing, bank credit is an even more important indicator of the economy.

Bank stocks prices also tend to follow bank lending, though typically with a lag of approximately one year. This has not happened recently; banks stock prices have declined even as lending has started

2 **SAVINGS RATES ACROSS THE REGION**

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Euro Area	6.4	6.8	7.7	5.4	2.8	3.6	4.3	3.5	3.9	4.3
France	5.9	6.1	6.5	5.6	1.9	2.4	3.1	1.7	1.6	1.7
Germany	6.4	8.7	10.8	9.2	5.6	7.5	9.7	8.6	8.1	9.3
Greece	-0.6	-0.5	-2.9	-6.4	-10.0	-11.1	-13.0	-10.8	-9.9	-9.1
Italy	4.6	4.7	5.0	2.7	0.3	-0.4	-0.3	-0.9	-0.6	-0.1
Norway	25.0	26.9	25.4	27.6	19.1	20.3	22.6	23.5	22.5	23.9
Spain	7.7	7.3	6.6	4.8	3.9	2.8	1.3	1.9	2.8	2.9
Switzerland	17.4	19.0	14.5	7.6	13.0	18.4	14.3	14.5	13.7	N/A
United Kingdom	3.1	2.1	2.4	0.9	-1.7	0.2	1.2	-0.4	-0.9	-0.9
United States	2.7	3.7	1.6	-0.6	-2.1	-0.8	-0.1	2.0	2.4	3.0

Source: LPL Research, Organization for Economic Cooperation and Development (OECD) 08/07/16

Data are as of year-end 2014, most recent data available, except for Switzerland, which has data available through 2013.

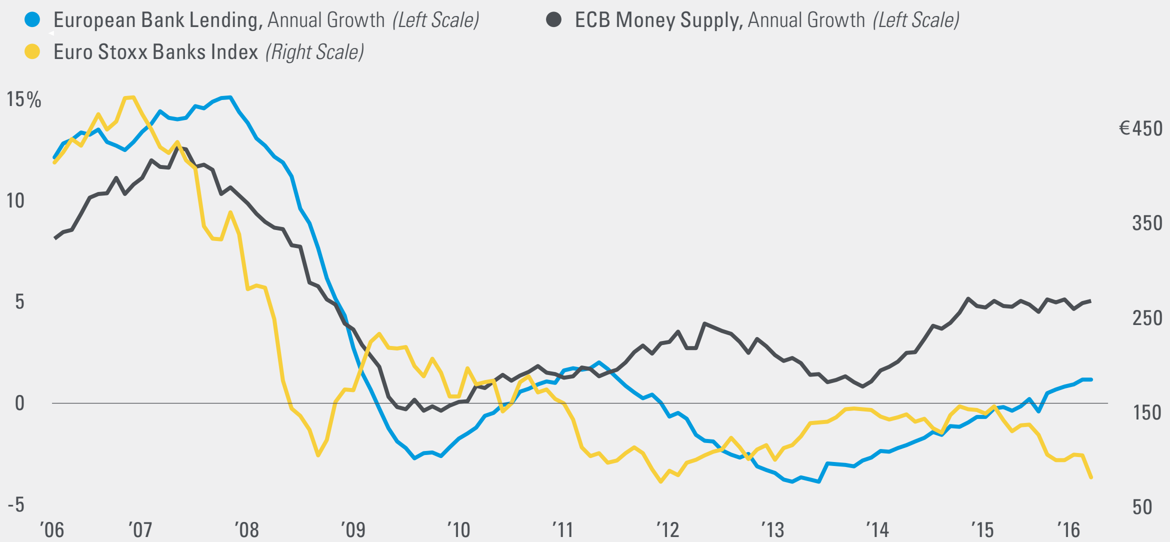
Savings Rate: Net household saving is defined as the subtraction of household consumption expenditure from household disposable income, plus the change in net equity of households in pension funds.

to increase. This is due to both low interest rates and concern about the credit worthiness of some of the major banks. The total amount of bank lending represents the "sales" for banks; interest rates represent the "price" of what they are selling. Total sales are starting to increase. But if rates stay low, or even decrease, it will be hard for European banks, and European stocks as a whole, to earn our vote for inclusion in portfolios.

CONCLUSION

In our *Midyear Outlook 2016: A Vote of Confidence* publication, we expressed a generally cautious view on European equities; we're looking for improved earnings and an appropriate response to Brexit before we could "vote for" increasing our allocation to the asset class. European banks, both as investments themselves and through their importance to the economy, represent an important factor in this decision. ■

3 ECB ONLY STARTED AGGRESSIVELY INCREASING MONEY SUPPLY IN 2014



Source: LPL Research, Bloomberg 08/07/16

The Euro Stoxx Banks Index is capitalization-weighted index of companies based in the European Union in the banking sector. There are 30 stocks in the index. It is an unmanaged index and cannot be invested into directly.

Performance is historical and no guarantee of future results.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

International investing and international debt securities involve special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

INDEX DESCRIPTIONS

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