Trade Booster

3 June 2014

ECB action to boost the relative valuation case for Eurozone equities

Summary

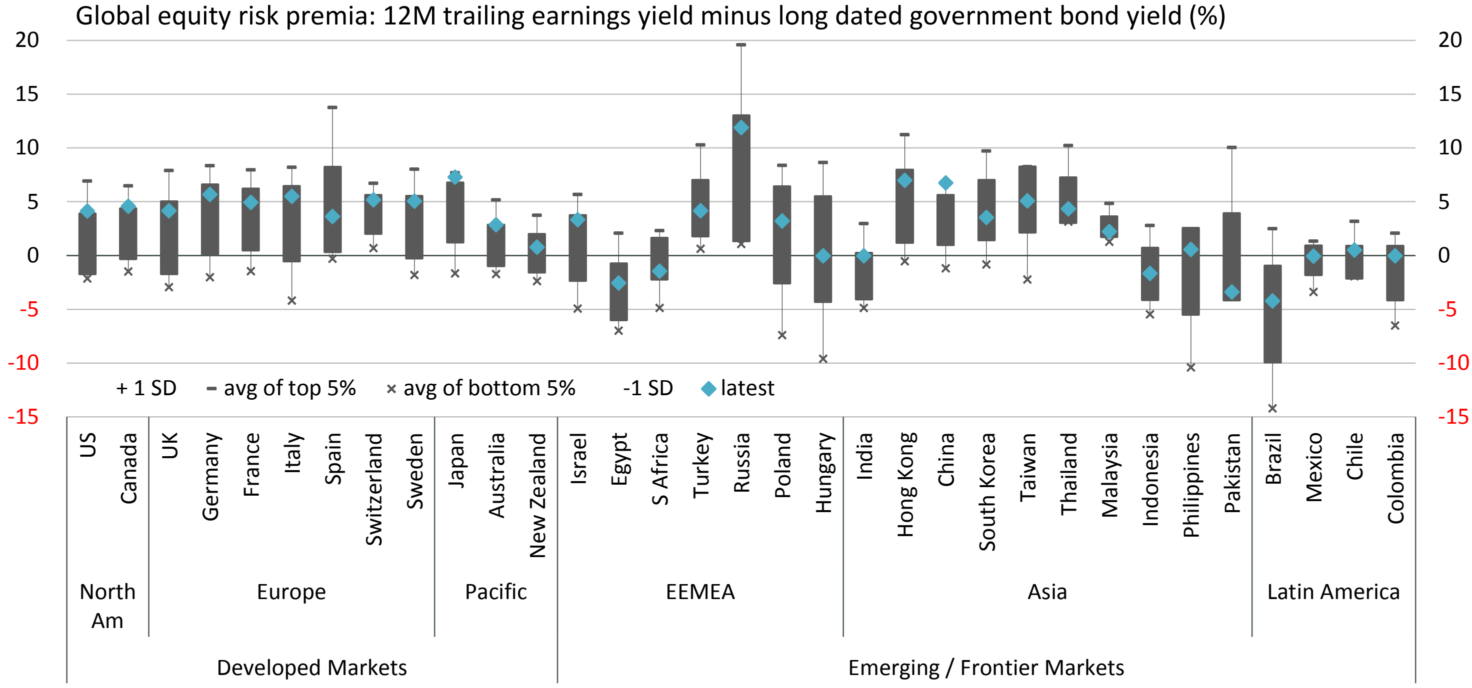
- **The ECB's policy decision this week may go beyond a rate cut alone. A targeted response to revive lending to SMEs will strike at the heart of Eurozone's balance sheet recession.**
- **Such stimulus would be supportive for bond markets in Eurozone's weaker economies, as investors' concern there is macro stability. Inflation risks loom larger in the US, UK and Japan.**
- **Italy's interest rate sensitive equity market may regain momentum. Low government bond yields underpin the attractive equity valuations in the rest of the Eurozone.**
- **Investors who share this sentiment may consider the following Boost ETPs *(www.boostetp.com/products)*:**

Long equities:

1. Boost FTSE MIB 3x Leverage Daily ETP (3ITL)
2. Boost LevDAX 3x Leverage Daily ETP (3DEL)
3. Boost EURO STOXX 50 3x Leverage Daily ETP (3EUL)

ECB action would improve sentiment in bond markets and strengthens the relative valuation case for Eurozone equities

Global equity risk premia: 12M trailing earnings yield minus long dated government bond yield (%)



Source: Boost ETP Research, Bloomberg. Data as at 30 May 2014

The ECB's policy decision this week is expected to go beyond a rate cut alone. It may entail a negative deposit rate which, combined with a third LTRO program and a further broadening out of banks' eligible collateral to obtain ECB funding would target stimulus at the core of Eurozone's credit deprived economy: the SMEs, which provide the overwhelming majority of economic value added and employment in the region.

The effect would be bullish for bond markets in Eurozone's weaker economies, as the ECB will more directly help promote banks grow their loan books, instilling economic stability in the process. While likely to revive inflation expectations somewhat, the real inflation risks loom larger outside the Eurozone, most notably in the US, UK and Japan. Eurozone banks would stand to benefit the most, as may Eurozone's interest sensitive equity benchmarks such as the FTSE MIB. Given the favourable valuations relative to bonds, both in a historic context and when compared to peers in DM and EM, other Eurozone equity markets should continue to appeal to investors as well.

Investors who share this sentiment may consider the following long equity ETPs:

Long equities:

1. Boost FTSE MIB 3x Leverage Daily ETP (3ITL)
2. Boost LevDAX 3x Leverage Daily ETP (3DEL)
3. Boost EURO STOXX 50 3x Leverage Daily ETP (3EUL)

Eurozone's balance sheet recession fails to end

Unconventional policy action by the ECB this week is widely anticipated. Driving it is the risk of disinflation becoming more entrenched as, amid a strong resilient euro, households are mired in a balance sheet recession (choosing to pay down debt as opposed to spend no matter how low interest rates are) while businesses are being denied access to affordable credit lines. This, in spite of negative real policy interest ratesfor several years. Since 2013 EUR 214 billion in credit to businesses in the Eurozone has been been withdrawn, equivalent to 2.2% of GDP. Meanwhile, households in the Eurozone have barely been able or wanting to borrow over the same period. For instance, at the same time that mortgage loans increased by a mere EUR 36 billion, consumer loans contracted by EUR 31 billion. Across countries there a stark differences, but for even Eurozone's healthier economies, there is evidence that any attempt to releverage has come at the expense of significant deleveraging elsewhere. When excluding Germany from Eurozone's healthier northern hemisphere for instance, the Benelux countries, France, Finland and Austria saw mortage loans grow by a combined EUR 63 billion since 2013. At the same time, consumer credit and business loans contracted by EUR 13 billion and EUR 11 billion, respectively. France's policy failures to reviving private sector employment, Netherland's falling house prices undermining the leveraged balance sheets and propensity to spend of households, and Finland's manufacturing supply shock amplified by the recent sale of Nokia's mobile phone business to Microsoft are some of the many symptoms undermining the recovery in Eurozone's northern hemisphere. Needless to say, within Eurozone's southern hemisphere, the credit contraction is happening on all fronts and while slowing, remains deep. Spain, Italy, Ireland, Portugal and Greece saw mortgage, consumer and business loans contracting by almost EUR 350 billion since 2013, or 11% of the group's GDP. It will take more than just 25 bps to bring about a sustained reversal in credit contraction and revive inflation.

Eurozone's banks may start lending only because the incentive to trade is no longer there

Up to now banks have focused on shrinking the loan book while boosting the trading book by taking advantage of profitable carry trade opportunties. Initially induced by the high bond yields in the aftermath of the the credit crisis, but spurred on by Basel III and the ECB's OMT program, the carry trade became a low cost low risk businesss, driving Italian and Spanish banks to amass huge quantities of high yielding domestic governments debt. For instance, relative to outstanding loans, Italian banks have since 2009 increased their exposure to government debt by 2.5x to 17%, while for Spanish banks the exposure to government debt has grown more than 3.5x to almost 13%. However, with bond yields falling back to precrisis levels and with most of the cheap LTRO loans from the ECB paid back, the opportunity to carry trade profitably has dissipated. Given the fallout of profitable carry trade opportunties, Eurozone banks may now have a bigger incentive to redouble efforts to growing their loan books and inject more credit into eurozone's economy.

New LTRO to focus on reviving business lending

Unlike the US, where bank loans account for only 20% of total commercal finance, in the Eurozone bank lending account for 80% of the total. As a result, the banks are the ECB's key transmittion channels through which any easing of monetary conditions can be implemented. So far, the transmittion of lower policy interest rates has failed because faced with low capital buffers and an ECB stress test, banks have tightened credit standards to the private sector. This is most notable in the southern hemisphere where high levels of bad debts in Italian and Spanish banks of 12% and 9%, respectively, have resulted in borrowing rates of business loans of less than 1 EUR million to average about 5%. When factoring in almost no inflation, such rates are neckbreaking in real terms and several hundred basis points higher than equivalent borrowing rates in France, Germany or the Benelux countries.

So what could the ECB do beyond a rate cut? It could set negative interest rates on their deposit facilities that banks can access, alongside opening up a another term loan facility for them, similar to LTRO 1 and 2. The first option is unlikely to be significant beyond speeding up the process by which Eurozone banks have already been steadily reducing their excessive reserve balances at the ECB. In 2012, excess reserve balances at the ECB's deposit facility peaked to over EUR 800bn per day. Given that pre-credit crisis excessive reserve balances were hovering around EUR 1.5 billion per day

(2006 to 2007), the potential for significant amounts of liquidity injection to the real economy in the near future is likely to be limited to the current levels of excess liquidity of around EUR 130 billion. However, when set against the combined contraction of private sector credit in Italy, Spain, Ireland, Greece and Portugal to the tune of EUR 512 billion since 2011, the measure alone will barely be a quarter of what is needed to just recoup the last two years of credit withdrawals, not to mention any additional credit supply needed to fund output expansion there, as well as in other Eurozone members.

Stimulus targeted towards ABS and broadening the range of eligible collateral

Hence, more stimulus from the ECB should be expected and LTRO 3 is likely going to help provide it. Likely to be designed at stimulating longer term lending to SMEs, the term facility may stretch several years with an interest rate low enough for banks to earn an interest rate margin sufficiently compensating them for the relative high risk associated with lending to SMEs. Spanish banks have recently restarted efforts to extend credit to SMEs, lured not least by the higher interest rate margins in the face of waning profitable carry trade opportunities in the bond markets as long-dated yield have fallen to pre-cris levels. While SME lending there is still highly selective, the trend of small business lending is encouraging. Loans of up to EUR 250K have risen by nearly 9% in 2013, while at the end of Q1 2014, such loans were up 5% from the same period last year.

Further out, once legislation and an institutional framework around it are put in place, the ECB could complement a LTRO facility with an asset backed securities (ABS) puchase program where pooled loans of SMEs are bought from banks and institutional investors. In an effort to revive activity in Eurozone's ABS market and increase lending to SMEs, the ECB has last year relaxed collateral requirements for banks, such as through reducing the haircuts on ABS posted as collateral to 10% from 16%, and reducing the ratings treshold below AAA for several ABS classes. While the ECB currently holds EUR 306 billion of collateral in ABS, banks have another EUR 726 billion of ABS as eligible collateral sitting on the balance sheet. Hence, the potential for further credit growth through relaxing collateral requirements has yet to be exploited in full. While SME related tranches will comprise a small part of the total ABS eligible assets, if the ECB together with supranational institutions such as the EIB would step in as buyers, liquidity and confidence would likely bring back foreign and institutional investors back to the fore, further increasing the demand for ABS. Packaged business loans, when sufficiently liquid, would complement the asset allocation mix of institutional investors who increasingly seek viable alternatives to yield deprived fixed income assets. Extending the eligibility of collateral to other types of assets has been developing only slowly but recently is taking more innovative shapes in Italy. The central bank there has gone a step further to promote SME lending by seeking to have banks' current account facilities approved as eligible collateral against ECB loans. Hence, as SMEs await customers paying their bills upon delivery of goods and services rendered, banks can supply short term funding and help facilitate working capital requirements.

ECB stimulus supports the relative valuation case for eurozone equities

The action by the ECB, because it is expected to be more wide ranging and more targeted, is likely to be a big sentiment boost for financial markets in the Eurozone as a whole. Risk assets, in particular eurozone banks stocks could stand to benefit the most. A stimulus targeted towards boosting SMEs lending is equivalent to promoting Eurozone growth at its core, since it is where most of the regions employment and economic value added is generated. For the loan books of Eurozone banks, this should mainly be seen as an opportunity to revive growth at a time when trading, investment banking and asset management is proving too crowded, too risky and because of the regulatory challenges, increasingly too costly.

The ECB action is unlikely to be bearish for bonds, not least because the inflationary impact, both in terms of expectations and actual trend, is unlikely to be major enough so as to trigger a shock effect in Eurozone bond markets. In fact, when compared to the US or UK, the recovery of the Eurozone has arrived late and remains muted. Hence, any inflationary risks are likely to materialise first in the US and the UK, and is already visible in Japan. That, in effect may help drive fixed income flows out of those countries and into the Eurozone. For Spanish and Italian banks, alonside Eurozone insurance companies loaded up with government debt, this is an added boon to their bond portfolio holdings.

For interest rate sensitive equity benchmarks in the Eurozone, most notably the FTSE MIB where the weight of financials comprise a third of the total, momentum is likely rekindled, particularly after weak Italian GDP pointing towards contraction triggered a sharp correction in both the bond and equity market earlier this month. Elsewhere in the Eurozone, equities continue to trade at attractive valuations, especially in light of the disinflationary trend that is helping suppress Eurozone bond yields. Compared to international markets, the relative valuation case for Eurozone equities remains compelling too. As summarized in our charts (see first page), the equity risk premia, or the difference between the equity market's earnings yield and long dated government bond yields, which currently hovers around 5% across most of Europe, is high not only by historic standards, but also compares favourably to its peers in DM and EM. Ahead of the ECB action later this week, European equities may present a buying opportunity for investors.

All data is sourced come from the ECB (www.ecb.int) and Bloomberg