INDOSUEZ
WEALTH MANAGEMENT

MONTHLY HOUSE VIEW

MARKETS, INVESTMENT & STRUCTURING – SEPTEMBER 2019

FOCUS

NO-DEAL BREXIT AND UK BANKS

EQUITIES

WAITING FOR DRAGHI AND POWELL

This is an excerpt of our Monthly House View. Should you wish to receive the full version, please contact us.

EDITORIAL

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POLICY MIX IN MOTION

"Since all these mysteries are beyond me, let us pretend to be their organiser"
Jean Cocteau, *The wedding of the Eiffel Tower* (1921)

Dear Reader,

No one among the Western leaders seems to illustrate this sentence better today than the US President who has continued to pressure the Fed for more action, complained about the limited magnitude of the rate cut of July, escalated the trade war with China and mentioned exploring additional tax cuts to sustain the US economy.

Discernible behind what is played on this theatre stage on Twitter and at the last G7 meeting are the fundamental trends that we described in this document in July: a deceleration in global growth and sluggish corporate earnings. We also highlighted that markets cannot rely on central banks alone to offset political risks and the trade war, both of which exacerbate the worrisome fundamental trends.

One trend that characterises 2019 in contrast to 2018 is the return of the policy mix in most major economies, as a way to fend off the effects of trade war and decelerating growth. That started in fact late 2018 with China adopting more accommodative fiscal and monetary measures. It continued in the US with the Fed's communication U-turn in January, leading to the first rate cut in a decade this summer, and which will likely be followed by additional ones as revealed by the tone of Jerome Powell's speech at Jackson Hole.

The return of policy mix is gaining Europe's shores as well. The ECB (European Central Bank) is preparing a full easing package for its September meeting, already priced-in by markets which trade the Bund at -60 basis points and Italian 10-year debt at 1.5% despite the political situation. The Italian - now deceased - coalition tried to end fiscal austerity last year, while France's response to the yellow-vest protests implied coming fiscal measures to calm the social tensions. Germany is close to recession and may now consider tax cuts and/or increased spending given the level of the national budget surplus. The new European Commission's agenda could reshape several aspects of the Stability Pact, in particular the supervision of fiscal policy and the magnitude of fiscal flexibility. The key question is whether this can effectively offset the decelerating business cycle and the growing fears of an upcoming recession that are visible among corporates and investors and arguably reflected in fixed income markets.

The lower-for-longer interest rate environment makes additional fiscal policy easing more sustainable, at least in the short-term. However, what is unusual would be to push both monetary and fiscal support simultaneously at this stage of the cycle. This says a lot about the fear of recession of our leaders... or about their fears of not being re-elected. On this topic, William Nordhaus' theory regarding political business cycles (1975) with governments arbitrating present and future welfare and driving the policy mix in order to get re-elected has probably never been more accurate than today.

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NO-DEAL BREXIT AND UK BANKS

The election of Boris Johnson as leader of the UK Conservative Party, and now the UK's prime minister, further increases the risk of a no-deal Brexit. In light of the current landscape, and focussing on sector impacts, the outlook for the UK's banks is undoubtedly negative as they remain most vulnerable to a no-deal Brexit. Fundamentally speaking, UK banks are well positioned from a capital, funding, and liquidity perspective, however, they may face issues if wholesale markets are disrupted for a lengthy period.

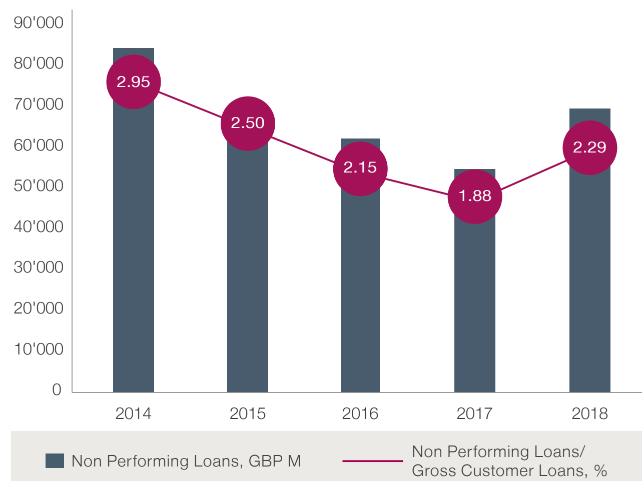
A key issue after the referendum vote in 2016 for UK banks was with regards to financial services passporting i.e. UK bank's ability to serve EU customers from any EU jurisdiction. Due to the sector's worst-case planning, few in the industry had assumed that financial services passporting would remain for UK banks post Brexit. Most banks in the UK are implementing their Brexit contingency plans to establish themselves in the EU through cross-border legal entity mergers and the establishment of additional licensed entities where required, however, for many of the larger institutions this is less of an issue as they already have sizeable subsidiaries in mainland Europe where they can continue to serve EU customers from.

A no-deal Brexit would lead to substantial disruption to UK economic and trade prospects, at least in the near-term. The impact of a no-deal Brexit on economic growth is undoubtedly negative, but a recession on the scale of that seen in the UK in the early 1990s, when real GDP declined by 2% over six quarters, would be a reasonable comparison for gauging the potential macroeconomic stress. At the same time, a fiscal and monetary policy response would follow a no-deal Brexit, mitigating the negative impact on the macroeconomic outlook. In its quarterly inflation report, the Bank of England's Monetary Policy Committee downgraded its forecasts for growth this year and next to 1.3% from a previous estimate of 1.5%, in a development that would mark the weakest economic expansion since 2012.

Relative to their European peers, UK banks will likely be the most vulnerable in a no-deal Brexit scenario, but even a severe macro-economic weakness leading to rising corporate insolvencies and weaker collateral values would only play through to bank asset-quality and undermine bank earnings and capital over time. Lower economic growth and higher unemployment will likely lead to higher credit losses and inevitably lead to stress in both the retail and commercial lending segments.

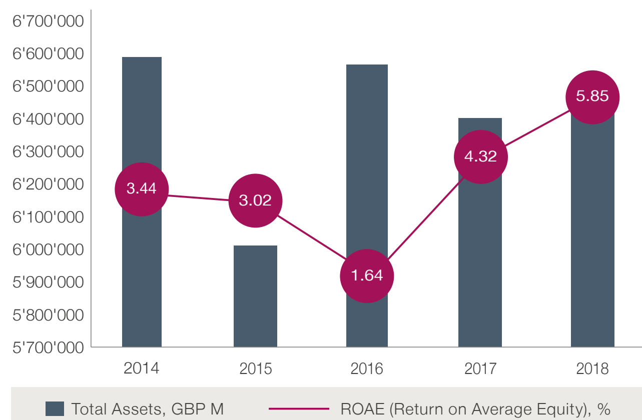
UK BANKING SECTOR HIGHLIGHTS 2014-2018

ASSET QUALITY



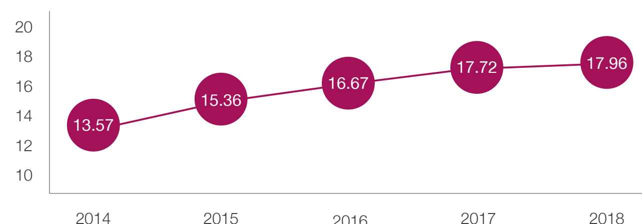
Source: S&P Market Intelligence, Indosuez Wealth Management
Past performance does not guarantee future performance.

PROFITABILITY AND MARKET SIZE



Source: S&P Market Intelligence, Indosuez Wealth Management
Past performance does not guarantee future performance.

CAPITAL ADEQUACY, TIER 1 RATIO, %



Source: S&P Market Intelligence, Indosuez Wealth Management
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NO-DEAL BREXIT AND UK BANKS

A differentiation can be made with regards to types of banks which may be affected. Less diversified banks, or banks that are more exposed to highly cyclical sectors, or those targeting niche economic segments or borrowers, are more vulnerable to the fall out of a disruptive no-deal Brexit than the larger and more diversified banks (by product and geography) in the UK. Thus, the negative economic impact from a no-deal Brexit may have a bigger effect on the smaller domestic lenders, “challenger” banks, and building societies given their focus on UK retail banking or property-related lending.

Another impact to consider is the effect a no-deal Brexit could have on wholesale markets. Wholesale market disruption would be unsupportive for the sector as a whole. Spread widening or funding disruption for the banks and other UK corporates could be more acute if the market perceived the UK sovereign to have weakened (we expect the UK sovereign to be downgraded by rating agencies under a no-deal Brexit).

How resilient is the UK banking sector to a significant stress? On 28 November 2018 the Bank of England (BoE) published the results of the 2018 stress testing for UK banks which showed the UK’s banking system is resilient to deep simultaneous recessions in the UK and global economies that are more severe overall than the global financial crisis, and that are combined with large falls in asset prices and a separate stress of misconduct costs. Despite facing loss rates consistent with the global financial crisis, the aggregate CET1 capital ratio of major UK banks after the stress would still be twice its level before the 2008 crisis. All participating banks remained above their risk-weighted CET1 capital and tier 1 leverage hurdle rates.

Despite the no-deal repercussions for UK banks, we expect their financial profiles to remain solid and provide a cushion to withstand any ensuing negative effects. This is supported by UK banks generally robust asset-quality, funding and liquidity profiles, and the BoE’s stress test data. Credit ratings for the majority of UK banks are generally in the investment-grade bucket implying their ability to withstand moderate downturns. Other banking sectors in Europe could also feel the impact under a no-deal scenario, particularly in open European economies like Ireland, Belgium, or the Netherlands, but we would expect those countries' banks to better accommodate its adverse consequences.

However resilient the UK banking sector may be, the ill-effects of a hard Brexit, and coupled with pressures stemming from a global economic slowdown, will certainly test business models.

NO-DEAL BREXIT: UK SECTOR IMPACT

SECTOR	VULNERABILITY	COMMENTS
Banks	high/medium	UK banks are well positioned from a capital, funding, and liquidity perspective. However, they may face issues if wholesale markets are disrupted for a lengthy period. Medium-sized and specialist lenders are more vulnerable. Any inability to service existing derivatives contracts cross-border could pose financial stability issues.
Corporates: Retails	high/medium	The UK retail sector is already under pressure from online competition and poor consumer confidence. A no-deal exit could accelerate the trend of retail failures due to increased prices from import duties and sterling depreciation.
Corporates: Real-estate	medium	London office space exposed to risk of weaker demand, while tenants in the UK retail sector may be at greater risk of failure. Weaker residential property prices would add risk for homebuilders. Warehouse and logistics real-estate may benefit if the speed of trade flow slows.
Corporates: Autos/aerospace	medium	Autos are exposed to lower sales and more complex and expensive manufacturing resulting from tariffs and supply-chain disruption, but company level impacts may vary depending on UK exposure. Tariffs would be lower for the aerospace sector than for autos but supply-chain issues could be equally disruptive.
Corporates: Airlines	medium	Risk of short-term disruption to flights, but airlines have the capacity to cope. Threat to traffic from an economic downturn and weaker confidence, while sterling weakness could hurt credit metrics due to currency mismatches between revenue, costs and debt structure.
Infrastructure: Ports/airports	medium	Traffic declines and increased costs would put pressure on cash flows, with significant short-term disruption to trade flows and flights if permissions to fly not secured. Volume risk would remain the main focus as weaker economic growth, inflation and sterling depreciation reduce traffic.

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