

ECB tapering: positive for Italian banks

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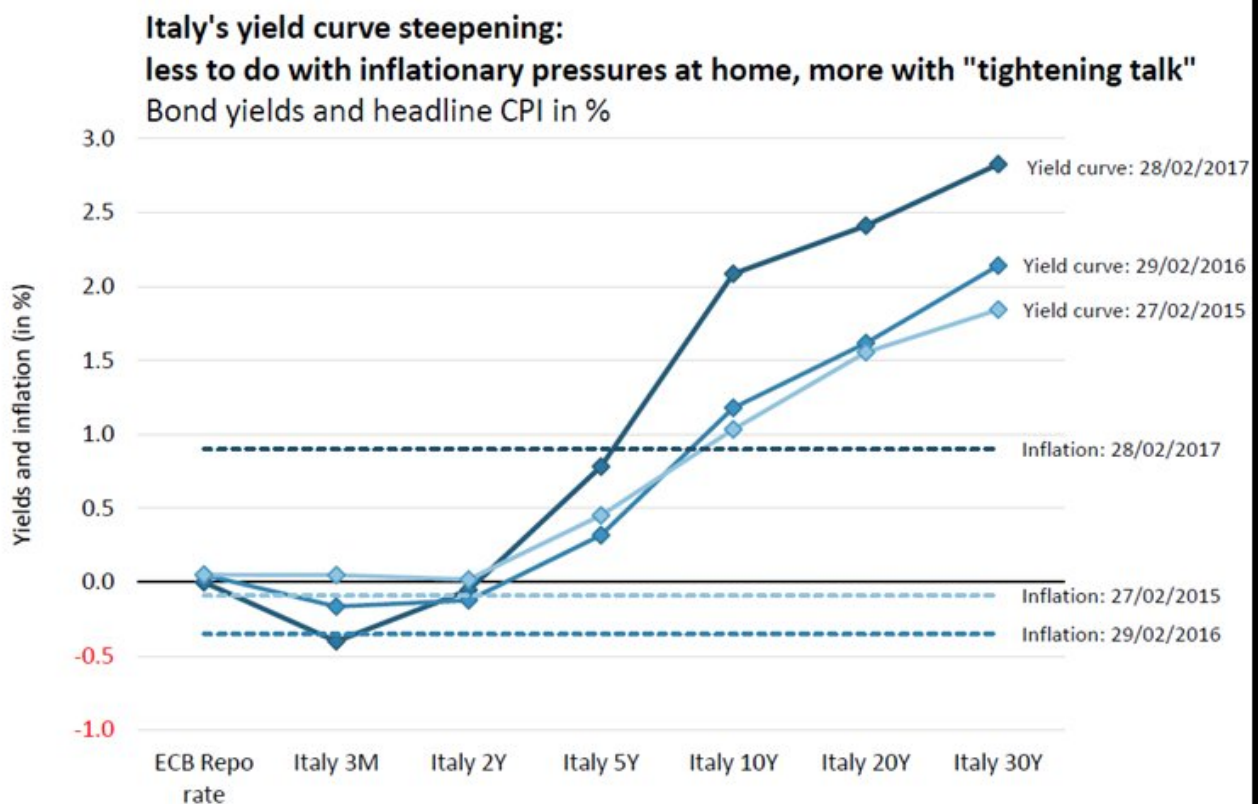
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The Eurozone's deeply discounted banking sector—particularly Italy's—offers investors a potential entry point as long-dated government debt comes under pressure and the yield curve steepening that this instigates has revived carry trade opportunities.

For the reasons outlined below, [bearish bonds and bullish banks](#) is a tactical asset allocation trade that may gain momentum as the ECB's rhetoric is less about the upbeat outlook on the Eurozone economy and more about giving Eurozone banks another shot at boosting profitability.

The chart below shows Italy's steepening yield curve, where the interest rate spread between 10Y Italian BTPs and overnight ECB borrowing is nearly 70 bps and is an additional 26 bps wider (96 bps) if you consider 3-month liquidity borrowing on interbank markets. Meanwhile, once you look within Eurozone countries, for many, including Italy, inflationary pressures remain largely absent.



Fading QE support and US rate hike pressure Euro sovereigns

This will be the last month when the ECB will buy EUR 80 billion of Eurozone investment grade (mainly government) bonds, after which it will continue to buy EUR 60 billion until December 2017. A smaller QE programme this year and its anticipated gradual unwind after 2017 means fading ECB support makes Eurozone weaker sovereigns more susceptible to speculative attacks.

Already there is evidence of QE being a less effective shock-absorber to this [year's general elections](#) in France (in April/May), Germany (in September) and potentially Italy (in the autumn or early 2018). Amidst increased discrimination in Eurozone bond markets, investors are driving the yield wedge across Eurozone sovereigns wider. For instance, while Italian bond yields have risen faster than most—likely a result of foreign investors continuing to speculate about Europe's obvious weakest (that is, most indebted)—“healthier” sovereigns now too show signs of vulnerability. French government bonds have recently come under selling pressure as (local) investors fluent in French politics may have increasingly allocated away from French government bonds in favour of covered (mortgage) bank bonds ahead of the [first round in the presidential stand-off in April](#).

The recent widely anticipated [Fed rate hike](#) merely works to reinforce the pressure on Eurozone bonds. The 10-year bond yield differential between US Treasuries and Bunds is a substantial 200 bps, with the crucial difference that inflation-adjusted US yields are positive, while in Germany they are negative. Undermining the fundamental case for holding Italian debt may be less obvious with yields only 10 bps lower than US Treasuries, but when set against the Euro's potential downside risk and perceived higher US creditworthiness, the risk adjusted yields in the US appear increasingly more attractive.

Banks profitability booster—reviving the trading book when NPLs overwhelm the loan book

As rising interest rates reduces the pressure of having to charge deposit account holders additional fees, the fight for defending deposit accounts eases too. But in Europe's peripheral economies the moribund, if not stagnant, loan book has fundamental structural weaknesses, including billions of NPLs in Italy that must be written down and a heavily indebted private sector that is still paying down debt. In the overbanked industry that prevails in Europe, such balance sheet restructuring will take years.

In response, banks in Europe are consolidating to cut costs and improve operating efficiency and leading the charge is, ironically, Italy. Its third largest bank, BPM Group, was formed last year through the Matteo Renzi backed merger between Banca Popolare di Milano and Banco Popolare. Other weak lenders must also bolster bank capital ratios to expand the loan book. Following its asset sale of Polish lender Pekao and of its investment arm Pioneer to be sold to Amundi, Unicredit has raised EUR 13 billion in equity and preferred stock to bolster its capital buffers.

But why should Italian lenders attempt to rebuild the loan book now when setting capital aside is expensive with moribund economic growth and a faltering labour market raising the risk of loan delinquencies and defaults? Boosting the trading book seems a more realistic alternative, especially with government debt now not only yielding much higher but also because Basel III regulations assigning a zero-risk weighting to government debt allows banks to accumulate government debt at no cost. Evidence of Italian banks rebuilding their trading book is the net purchases of EUR 9.5 billion in debt securities over the last

12 months to end-January 2017, stemming mainly from acquisitions of bank and mortgage bonds and corporate bonds. And, as interest rates continue to rise, the net redemptions of government debt are expected to reverse too.

Conclusion

We believe the large upside potential for Eurozone banks and Italian banks underpinned by the rising rates environment creates carry trade opportunities that are likely to gather momentum in 2017. The still deeply discounted valuations with which Italian banks trade relative to peers in Europe and to the broader equity market generally also continues to present a good entry point for investors.

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