M.M. WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY

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European monetary policy and bank regulation: A wake-up call

Twenty years ago, most could easily say what the bank they worked for actually did. It was called maturity transformation, a brilliant invention for both banks and the economy. It is advantageous to banks because it can be used to generate comparatively predictable returns that ensure a bank's continued existence and allow it to set aside capital for bad times. Maturity transformation is important for the economy because it is the link between personal savings and business investment. An economy without instruments of maturity transformation would have significantly more trouble financing capital investments and paying interest on private savings deposits.

The mechanism of maturity transformation is easy to explain. Assume that each of a large number of private customers has a small amount in their checking or fixed deposit account with short maturities. Since it is very unlikely that all customers will withdraw all their money from the bank on the same day, some of their deposits can be used by the bank to grant long-term loans or to provide long-term state financing by purchasing government bonds with a maturity of several years. Of course, the bank cannot use the total amount of deposits theoretically available for loans and investments in securities. Part of it must be "parked" with the central bank, for which a little interest used to be paid. The sample calculation for that is simple. Assume the interest rate on these deposits at the central bank was 2%. The bank would give its private customers interest slightly below that deposit rate and thus generate a margin. The size of the margin resulted from competition among the banks. The remaining funds on deposit would be granted as loans or used for investments in securities. Since the risks there are somewhat higher, that resulted in an even somewhat higher margin. Here, too, competition and the market ultimately determined how large this margin would be in particular cases. Banks were able to thrive in this environment, and the economy – and hence private customers and businesses – benefited overall from the effects of well-functioning maturity transformation. Ah, those were the days!

What does the world look like now? At first glance, not so different. But behind the scenes, we find dramatic dislocations with the negative effects of increasingly disrupted maturity transformation. Of course, cash deposits from private and business customers still exist today. Unlike the past, however, banks can no longer make a margin there. For, the ECB's deposit interest rate stands at -0.4%, with banks being unable to pass on this interest cost on to customers. This usually means that a bank makes an ever-greater loss with each additional euro that a customer transfers to their account. Certainly, one could object that the bank does not have to "park" its customers' deposits at the central bank, but could give out at least some of the funds for loans or government finance (by purchasing bonds) in order to conduct maturity transformation in the conventional sense. And that is exactly where the catch is. Purchasing bonds practically does not make sense any more against the background of the ECB's quantitative easing policy. Buying stocks would be a theoretical alternative (in principle, stocks run in perpetuity, thus making for perfect maturity transformation), but that is subject to very tight regulatory restrictions. As if that were not enough,

lending and the internal processes it entails have become so complicated due to regulatory proliferation in the banking sector in recent years that the attainable margins are hardly large enough to compensate adequately for the risks and costs. And it gets worse. Extremely high capital requirements are making it ever more difficult for banks to grant loans at all.

Here, if not sooner, the completely schizoid character of European monetary policy and banking regulation becomes apparent. On the one hand, a negative deposit interest rate is being used to "force" banks to grant loans and thereby engage in maturity transformation. On the other hand, regulatory intervention and capital requirements make it almost impossible to grant those loans. This necessarily leads to dwindling bank profits and hence to less efficient provision of capital with the result that the entire banking industry enters into a negative spiral that benefits no one.

Anyone who does not want to follow this line of argument should compare the earnings trend of US banks with that of European banks. While US banks are now brimming with strength and the US economy is benefiting greatly from high-performing banks, the European economy is suffering from banks that have gained only little in substance since the financial crisis. This is a dangerous trend, which will come back with a vengeance in the next recession, if not sooner. For, especially in bad times, banks need a "buffer" enabling them to continue granting loans and conducting maturity transformation. They have not been able to build up such a buffer, however, so a dramatic collapse of lending may be expected in the next big crisis. Historically, it is ironic that the central bank cannot even counter with low interest rates in this situation, since they are already low.

However, the current situation is already inevitably disrupting maturity transformation, and that is reflected in the data. Lending in the euro zone is only growing very slowly, although the economy is humming. Moreover, the money supply growth rate is dramatically higher than the growth rate of lending – an unmistakable sign that something is wrong. The interesting thing here is that even politicians and supposed experts outside the financial service sector hardly recognize these deficiencies as such. Far too often, unfamiliar with the details of the processes and in nearly academic detachment, they draw a picture that does not correspond to the facts. So, it is hardly surprising that it has taken so long for voices finally to be heard seeking at least in part to correct this precarious situation. To be fair, Germany's central bank must be given credit for having long held a comparatively reasonable position here, but it is now gratifying that the French central bank believes that things cannot go on this way much longer. In that spirit, the governor of the French central bank tentatively announced a few days ago his intention to support an increase of the deposit interest rate in the coming year.

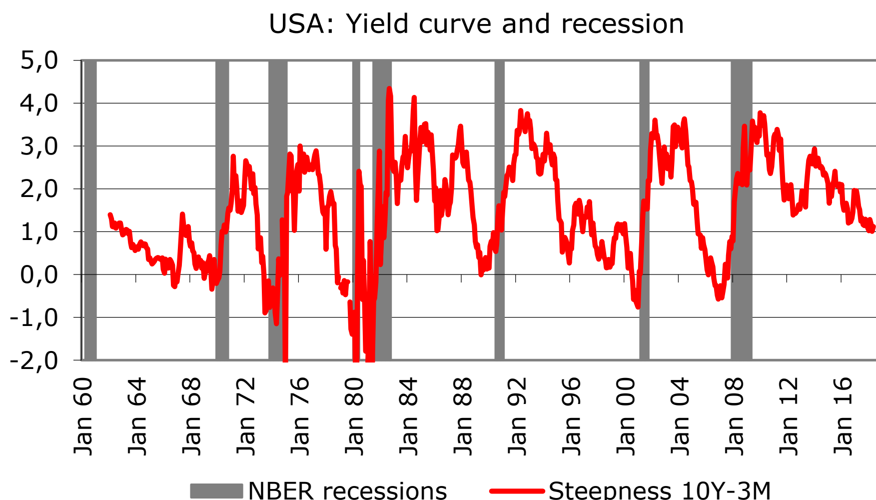
Is this now finally the long-awaited ray of hope on the horizon? Will the central bank and government agencies have actually recognized the emergency and resulting need for action? We do not think so. Instead, the latest deliberations to centralize banking regulation and supervision even more strongly than heretofore at the European Securities and Markets Authority (ESMA) in Paris make us fearful. That body is becoming a bureaucratic monster even more remote from conditions specific to individual banks than a national supervisory authority. Moreover, its focus is directed by a rather Francophile orientation to the big banks. This orientation does not do justice to the intensely competitive German banking scene populated by many small institutions. Accordingly, great merger waves in the German banking sector are becoming more likely. And that will give rise to new systemically relevant banks that will have to be bailed out by the taxpayers again in the next crisis. It would almost be funny, if it were not so sad.

Weekly outlook for May 21-25, 2018

	Jan.	Feb.	Mar.	Apr.	May	June	Release
DE: PMI, manufacturing - flash	61.1	60.6	58.2	58.1	58.3		May 23
DE: PMI, services - flash	57.3	55.3	53.9	53.0	53.3		May 23
DE: Ifo business climate index	104.8	104	103.3	102.1	102.5		May 24
DE: Ifo current conditions	101.4	100.3	100	98.7	99.4		May 25
DE: Ifo business expectations	112	110.9	110.7	109.4	109.6		May 25
DE: GfK Consumer climate	10.8	11	10.8	10.9	10.8	10.9	May 25
EUR19: PMI, manufacturing - flash	59.6	58.6	56.6	56.2	56.4		May 23
EUR19: PMI, services - flash	58.0	56.2	54.9	54.7	55.0		May 23
EUR19: Consumer confidence - flash	1.4	0.1	0.1	0.4	0.5		May 23

MMWB estimates in red

Chart of the Week: Focus on US yield curve



The notion that a flat or even inverse yield curve in the United States always precedes a recession and may thus be taken as a warning sign lingers more or less stubbornly on the financial markets. A flat yield curve arises whenever the yield on bonds with long maturities is roughly at the same level as the yields of short-dated bonds. An inversion occurs when the yields on long bonds actually fall below those on short bonds. At present, for example, the interest rate difference between US government bonds with a residual maturity of 10 years and those with a residual maturity of 3 months is just over 1 percentage point. That is an extremely low number and makes little economic sense because long bonds carry a higher risk than short ones. In the past, such a flat yield curve has very often heralded a recession, and naturally the question arises why things should be different this time. However, in our view, there is actually a good reason to believe that history will not repeat itself. For, the yield curve is not flat because the yield on long bonds is falling due to bad data, but rather because the yield on short bonds is rising due to good data and resulting higher policy interest rates. So, we remain optimistic. Moreover, the countermovement of recent days, in which 10-year US government bonds have risen above 3% for the first time since the quantitative easing program ended, has stopped the trend towards a flatter yield curve for the time being.

Market data overview

	As of	Change versus			
	18.05.2018	11.05.2018	17.04.2018	16.02.2018	29.12.2017
Stock marktes	14:49	-1 week	-1 month	-3 months	YTD
Dow Jones	24714	-0,5%	-0,3%	-2,0%	0,0%
S&P 500	2720	-0,3%	0,5%	-0,4%	1,7%
Nasdaq	7382	-0,3%	1,4%	2,0%	6,9%
DAX	13076	0,6%	3,9%	5,0%	1,2%
MDAX	26837	0,5%	3,6%	2,5%	2,4%
TecDAX	2807	1,0%	5,9%	8,9%	11,0%
EuroStoxx 50	3580	0,4%	2,9%	4,5%	2,2%
Stoxx 50	3162	0,9%	3,9%	3,4%	-0,5%
SMI (Swiss Market Index)	8967	-0,3%	1,7%	-0,2%	-4,4%
Nikkei 225	22930	0,8%	5,0%	5,6%	0,7%
Brasilien BOVESPA	83622	-1,9%	-0,6%	-1,1%	9,4%
Russland RTS	1178	-1,3%	5,1%	-6,7%	2,1%
Indien BSE 30	34848	-1,9%	1,3%	2,5%	2,3%
China Shanghai Composite	3193	0,9%	4,1%	-0,2%	-3,5%
MSCI Welt (in €)	2126	1,1%	5,5%	5,3%	3,0%
MSCI Emerging Markets (in €)	1144	-0,4%	3,2%	1,0%	0,7%
Bond markets					
Bund-Future	163,14	429	380	453	146
Bobl-Future	130,86	-19	-30	16	-75
Schatz-Future	111,91	0	0	2	-7
3 Monats Euribor	-0,33	0	0	0	0
3M Euribor Future, Dec 2017	-0,29	1	2	-3	0
3 Monats $ Libor	2,33	-1	-2	45	64
Fed Funds Future, Dec 2017	2,22	1	8	19	0
10 year US Treasuries	3,10	12	28	20	69
10 year Bunds	0,63	7	12	-3	20
10 year JGB	0,06	1	2	0	1
10 year Swiss Government	0,12	5	10	0	25
US Treas 10Y Performance	551,32	-1,1%	-2,5%	-1,5%	-5,2%
Bund 10Y Performance	599,57	-0,7%	-1,1%	0,8%	-1,3%
REX Performance Index	478,67	-0,3%	-0,4%	0,7%	-0,4%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,88	7	10	10	20
IBOXX BBB, €	1,56	9	19	21	32
ML US High Yield	6,52	3	24	10	37
JPM EMBI+, Index	789	-1,3%	-3,6%	-3,4%	-5,7%
Convertible Bonds, Exane 25	7471	0,0%	1,2%	2,3%	1,0%
Commodities					
CRB Spot Index	443,39	-0,1%	0,6%	0,3%	2,5%
MG Base Metal Index	350,70	-0,3%	-1,0%	-4,2%	-2,2%
Crude oil Brent	79,62	2,8%	11,2%	22,7%	19,5%
Gold	1286,79	-2,6%	-4,2%	-5,1%	-1,3%
Silver	16,48	-1,7%	-1,7%	-1,5%	-3,1%
Aluminium	2303,00	1,1%	-4,3%	3,8%	2,1%
Copper	6857,00	-0,7%	0,4%	-4,6%	-4,9%
Iron ore	67,26	-0,3%	4,7%	-12,5%	-5,6%
Freight rates Baltic Dry Index	1305	-11,3%	24,0%	20,4%	-4,5%
Currencies					
EUR/ USD	1,1766	-1,4%	-4,8%	-5,6%	-1,9%
EUR/ GBP	0,8730	-0,9%	1,2%	-1,5%	-1,7%
EUR/ JPY	130,52	0,1%	-1,4%	-1,4%	-3,3%
EUR/ CHF	1,1762	-1,4%	-1,2%	2,1%	0,5%
USD/ CNY	6,3765	0,7%	1,5%	0,5%	-2,0%
USD/ JPY	110,77	1,3%	3,5%	4,2%	-1,7%
USD/ GBP	0,74	0,6%	6,2%	4,2%	0,4%

Carsten Klude
+49 40 3282-2572
cklude@mmwarburg.com

Dr. Rebekka Haller
+49 40 3282-2452
rhaller@mmwarburg.com

Martin Hasse
+49 40 3282-2411
mhasse@mmwarburg.com

Dr. Christian Jasperneite
+49 40 3282-2439
cjasperneite@mmwarburg.com

Bente Lorenzen
+49 40 3282-2409
blorenzen@mmwarburg.com

Julius Böttger
+49 40 3282-2229
jboettger@mmwarburg.com

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