Deutsche Bank Is Crashing Again as European Banks Slide to Crisis Lows

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As of this moment, various European banks but most prominently Deutsche Bank…

… as well as Credit Suisse and RBS, have been crashing back to lows hit in early February and then all the way back to the March 2009 "the world is ending" lows. We commented on this yesterday using, ironically enough, a note by Deutsche Bank strategist Jim Reid, in which we showed all the things that were not supposed to happen when Draghi unleashed his massive quad-bazooka QE expansion.

The problem is that now that global central banks are more focused on appeasing China and keeping the USD weaker (by way of a dovish, *non*-data dependent Fed), the pain for Europe (and Japan), and their currencies, and their banking sector, will likely only get worse. This is precisely the case proposed by Francesco Filia of Fasanara Capital, who explains below his "Short European Bank Thesis."

Here is his note:

Here below, we update our views on negative rates and our consequential short European Banks equity and sub debt thesis. In a nutshell, we think that not only no bank is ever designed to survive in an environment of deeply negative rates for a prolonged period of time, but their business model is further impaired by negatively sloping interest rate curves. In a twisted unwelcome side-effect following ECB meeting, curves are ever closer to inversion in Europe. They recently became inverted in Japan, for the first time since 1994.

Drivers below, in no particular order:

1. Deeply negative interest rates for a prolonged period of time.

Banks' business model is at risk. If deeply negative interest rates is the way forward, it doesn't matter consolidation or bad banks talks or country-specific policymaking (e.g. Italy or Europe): the business model is impaired, needs a rethink/restructuring, even before FinTech is taken into account. No bank is ever designed to function in durable negative rates environment. It is a profitability issue, not a balance sheet problem. Banks' capitalisation then, however healthy it may seem today, may have to be looked at as no more but the number of years of negative profitability it can withstand before a recap is eventually needed. A fragile banking sector is the Achilles heel of the equity market overall, paving the way for gap risks to the downside.

2. Inverted interest rate curves.

Now then, one more element is potentially adding to negative rates in impacting banks' business: negatively-sloping interest rate curves. The spread between 10y JGBs and overnight rates turned negative in Japan last month. The same spread in Germany is only 20bps steep. Charts attached below. The curve steepness tightly correlates, in broad terms, to how much of a spread profit is left for banks when lending to good large businesses in Europe. No creditworthy business in Europe will accept borrowing for the longer term at much higher costs than that, especially when factoring in a weak-inflation environment. Incidentally, such business is better off borrowing for shorter terms, at more inverted curves, for then rolling-over such debt at a time when it has better visibility on how things evolve in the real economy and if the inflation outlook deteriorates from here or not.

3. In deflationary economy, demand for loans is anaemic.

By subsidising T-LTROs to the private business sector, Draghi was masterful in avoiding immediate damage to the banking sector. Banks' agonising core business model was given a breathing space, in the name of helping the real economy. Surely a smart and well-thought system of incentives. However, as Keynes once wrote, quoting the old English proverb, "You can lead a horse to water but you can't make him drink". The lack of positive real expected returns dampens new investments in hiring plans, plant & machinery, and related borrowing and credit formation with it. Thus, making Draghi's move just another artefact of financial leverage, not a game changer.

4. No more safety net in the near term for markets.

If anything, Draghi has now gone closer to full exhaustion of his arsenal of policy tools. Last year, we estimated for Central Banks to be 70% done; we may now argue for their arsenal to be more than 80% exhausted. Their lack of policy space from here is evident. The failed repression of volatility post ECB and the reaction of the EURUSD are there to testify it. Current policies can be expanded, new tools can be devised, but their marginal effectiveness is clearly free-falling. Next time around, a troubled equity market will have less of a safety net in the build-up of expectations into the subsequent ECB meeting.

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In consequence of the risk assessment above, we resolve to stay out of banks equities and equity-like instruments (while we like banks' senior debt) and equities in general, for limited upside is combined with the risk of a sizeable sell-off in the months ahead. We stay put. We keep dry powder ready should the market become way cheaper between now and September, as we expect.

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Japanese 10yr JGB vs Japan Overnight Rate
The Japanese curve (10yr JGB's minus overnight rate) is inverted

German 10yr Bund vs Refi Rate

Ratio of EU Banks / Eurostoxx vs German 10yr Bund

Banks tend to underperform the broader market index when interest rates fall

Ratio of EU Banks / Eurostoxx vs European Interest Rate Curve

Banks tend to underperform the broader market index when interest rates curves flatten/invert

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