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MACROCOSM

Europe's Ghosts of Stress Tests Past

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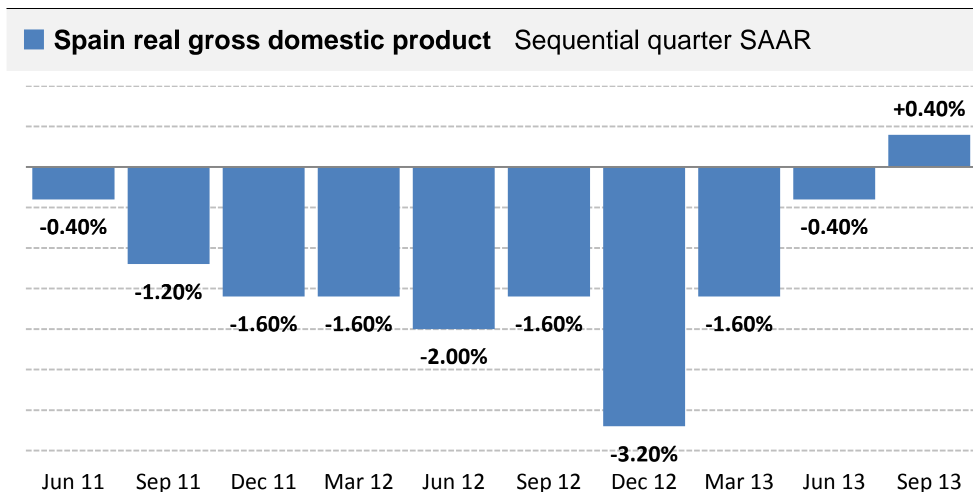
Donald Luskin, with research input from **Lorcan Roche Kelly**

A risk-off spasm over ECB bank tests ignores the euro area's quantum turnaround.

Euro area equities -- especially financial stocks -- had a big risk-off day yesterday, on the announcement of a new bank capital review by the European Central Bank. This is preparatory to its new regulatory role next year as overlord of a new Single Supervisory Mechanism (SSM).

- Ironic, because yesterday the Banco de España estimated Q3 real GDP growth for Spain at 0.4%, the first positive-growth quarter in more than two years (please see the chart below).

Spain real gross domestic product Sequential quarter SAAR



Source: Eurostat, 9/13 Bank of Spain estimate TrendMacro calculations

- Spain is tied with the United States as 2013's second-best performing major equity market, behind only Japan. It has long been our favorite recovery play in the euro area, powered by significant supply-side reforms in its over-regulated labor market (see "Europe's Supply-Side Revolution" February 17, 2012).
- We focus on Spain here only because its recovery is uniquely important to the region. Spain is the hinge of euro area stability -- among the so-called PIIGS, it uniquely combines a very large economy with large fiscal deficits. But *all* the nations of peripheral Europe have undergone substantial improvement along many dimensions of economic stability and market performance.

Update to strategic view

EUROPE MACRO, ECB, EUROPE FINANCIAL STOCKS, EUROPE STOCKS: No sticker-shock in the ECB's Asset Quality Review -- the same capital thresholds already imposed by Basel III and the Financial Stability Board, and lower than in previous stress tests. We don't see why banks of any consequence should have any difficulties here. In any event, no test results for over a year. Irrelevant anyway, considering the powerful stabilizing force of a return to growth symbolized by Spain's first positive GDP quarter in more than two years. Sharp gains over the last quarter leave euro area bank stocks, and stocks in peripheral nations overall, vulnerable to corrections on new like this. But the theme of the euro area's recovery from crisis and from recession will march on.

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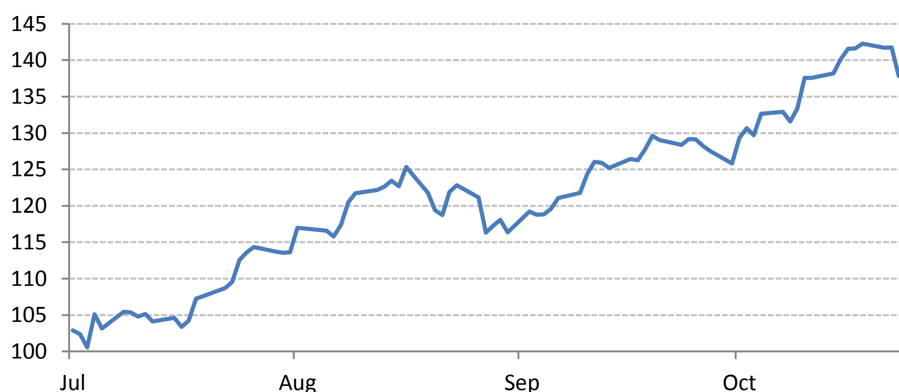
- *<u>In this context, a risk-off spasm in the wake of the announcement of ECB bank reviews -- not even stress tests -- amounts to letting one's self be haunted by mere ghosts of long-dead risks.</u>*
- To be sure, it didn't help that yesterday ECB president Mario Draghi gave Europe's anti-euro English-speaking media an irresistibly bearish soundbite. In a Bloomberg interview, defending the rigor of the review process, he said "the banks do need to fail to show its credibility. If they do have to fail, they have to fail."
- That's a lot of the word "fail" in the same breath as the word "bank." But Draghi isn't talking about "bank failure," he's talking about banks failing to meet capital the requirements revealed yesterday under the ECB's Asset Quality Review (AQR).
- *<u>None of this has any even remotely immediate impact.</u>*
- The AQR will begin in November, and will take a year to complete.
- And the capital bar hasn't been raised on the banks. Most euro area banks will be required to maintain a total capital threshold of 7% common equity Tier 1 -- consisting of a common equity Tier 1 ratio of 4.5% plus a 2.5% capital buffer. The most systemically important banks will have to maintain an additional 1% buffer.
- *There shouldn't be any sticker-shock here. This is in-line with requirements under Basel III rules and with capital surcharges already recommended by the multinational Financial Stability Board, and it is more lenient than the 9% used in earlier euro area stress tests.*
- *<u>So the base case has to be that unless there has been severe recent deterioration, or unless the AQR uncovers outright fraud, that most banks should be in compliance, or able to get there without catastrophically dilutive capital raises.</u>*
- Indeed, last month ECB vice president Vitor Constâncio said, "the median common equity tier one capital of European banks is slightly above the median of US banks… The situation of the European banks is better than market perceptions." Quite the heroic thing to say, actually, considering how favorable market perceptions expressed in recent euro area bank stock prices have been since mid-year (please see the chart below). Nevertheless, we're inclined to agree.

STOXX euro area bank stock index



Source: Bloomberg, TrendMacro calculations

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Bottom line

No sticker-shock in the ECB's Asset Quality Review -- the same capital thresholds already imposed by Basel III and the Financial Stability Board, and lower than in previous stress tests. We don't see why banks of any consequence should have any difficulties here. In any event, no test results for over a year. Irrelevant anyway, considering the powerful stabilizing force of the return to growth symbolized by Spain's first positive GDP quarter in more than two years. Sharp gains over the last quarter leave euro area bank stocks, and stocks in peripheral nations overall, vulnerable to corrections on new like this. But the theme of the euro area's recovery from crisis and from recession will march on.