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How global bank shares suddenly became unattractive

by James Chessell

In times of great stress it helps to keep a sense of humour. So when Nassim Taleb, the academic and best-selling author of *The Black Swan*, tweeted on Tuesday that he "had no concern over Deutsche B until the German Finance Minister stated we should have no concern over Deutsche B", he seemed to sum up the mood of the markets.

German finance minister Wolfgang Schaeuble had indeed declared he was unperturbed about the brutal sell-off of Deutsche shares by investors worried about the bank's funding and profitability.

Elsewhere, Deutsche's newish chief executive, John Cryan, attempted to allay market fears by assuring staff its financial position was "absolutely rock-solid".

And, in case anyone missed it, German MP Hans Michelbach, a ranking member of the Bundestag's finance committee, declared Deutsche's woes weren't "so much a reflection of the business model of the bank but [reflected] an overall sense of insecurity in the markets."

> "I had no concern over Deutsche B until the German Finance Minister stated we should have no concern over Deutsche B pic.twitter.com/w4YRC0fC8F"
>
> — NassimNicholasTaleb (@nntaleb) February 9, 2016

None of this reassurance made much difference.

Investors are increasingly reluctant to put their faith in policymakers, central bankers or CEOs when it comes to the world's commercial lenders. This week the likes of Deutsche, Credit Suisse, and Societe Generale were subject to a brutal sell-off that – despite a short-lived relief rally on Wednesday – shows no signs of abating.

Shares in European banks are down nearly 30 per cent this year, but heightened market insecurity is not confined to the continent. US financial stocks are down close 20 per cent; Japanese banks are about 35 per cent lower. Australian banks have also been caught up in the carnage.

It wasn't meant to end up this way. For the past couple of years investors have taken comfort in the knowledge that central banks would act as a backstop preventing another collapse of the world's financial system. Nowhere has this been more evident than in the world's biggest single market,where European Central Bank president Mario Draghi famously pledged in 2012 to do "whatever it takes" to protect the eurozone.

Bail everyone out

But not everyone is convinced. Stephen Issacs, a strategist at Alvine Capital Management, likens it to believing in a "fairy godmother" who will "bail everyone out".

As the economies around the world fail to stimulate growth, and global currency wars heat up, more central bankers have pushed official interest rates into negative territory. Sweden, Denmark, the EU and, most recently, Japan have joined the sub-zero club. Close to a quarter of the world's economic output now comes from countries with negative rates.

Until recently, it had been widely thought that it would be imprudent for central bankers to push borrowing rates into negative territory. Charging depositors would simply cause them to switch to cash.

But now negative rates are accepted as a useful part of the central banker's toolkit. The policy is meant to omplement stimulus, such as quantitative easing, by encouraging banks to embrace riskier lending that will promote growth in weaker parts of the economy.

Lower borrowing costs in Europe have helped the ECB fight deflation and weaken the euro, which assists countries such as Germany that rely on exports. Or so the theory goes. Central bankers have also been heartened that deposits have remained stable in Europe where most banks have absorbed the cost of negative rates rather than pass them on to customers.

The problem with this strategy is that it's untested, and making investors increasingly nervous. This anxiety bubbled into something approach panic on Thursday when Sweden's Riksbank – the world's oldest central bank, and the first to go negative in early 2015 – cut its main interest rate even further below zero.

The cut was more aggressive than expected and Riksbank governor Stefan Ingves made no secret that he would be prepared to go lower to boost inflation and ensure the Swedish krona remained competitive against the euro. With the ECB expected to cut already-negative rates again in March, Ingves said: "we most relate our policies to what is going on in the rest of world."

This latest salvo in the currency wars served as nasty reminder that rates are likely to go deeper into negative territory and for longer.

"While there is no longer any doubt about the ability or willingness of many central banks to manufacture negative interest rates, their efficacy on growth or inflation is far from certain," says PIMCO strategist Scott Mather. "Instead, it seems that financial markets increasingly view these experimental moves as desperate and consequently damaging to financial and economic stability."

'Negative interest rates are disastrous'

Of particular concern for markets is the impact of negative rates on bank profits. Negative rates mean lenders' interest margins are reduced and their cost of capital is increased as spreads on debt and equity expand to compensate for reduced profitability. Not passing on the increased costs to customers exacerbates the problem. This partly explains why banks in Europe and Japan have underperformed their US peers.

"Negative interest rates are disastrous", Issacs said this week. "It is effectively a tax on earnings".

In this sense the sell-off of banking shares this week is less to do with solvency and more to do about profitability. This is certainly the view of Goldman Sachs boss Lloyd Blankfein, who told an investment conference in Florida this week: "The analyst community hasn't really recognised enough how much safety and soundness has been plugged in ... I think the market has been forced to accept lower returns, [but now banks are] a lot safer and I don't think that cost of capital reduction is really reflected in the market."

Most sensible observers do not expect major banks to go bust any time soon, as they are better capitalised than before the global financial crisis. However, investors are fast coming to conclusion that returns are going to be subdued. And while negative rates may have been a driving force of this week's dramatic sell-off, there are plenty of other factors at play. China's economic lowdown, speculation about a recession in the US, defaults by energy companies hit by the weak oil price, and the spectre of more fines for misconduct have all contributed to the declines.

The problem for banks is that the market's anxiety is feeding on itself. Nowhere is this more apparent than with Deutsche, which has generated flat or negative earnings for shareholders since the GFC.

"For those with an understanding of debt and credit markets this isn't a huge surprise: banks will very often slowly bleed out losses over a period of time," argues Andrew Papageorgiou, co-founder and investment manager at Melbourne-based fixed-income investor Realm Investment House.

"The issue is, however, that equity-holders are fairly losing patience and are becoming increasingly concerned on asset quality. The problem with a collapsing equity price is that the banks are seeing the biggest part of its regulatory capital structure written off, which in turn limits the banks' ability to raise additional capital as circumstances deteriorate."

Little wonder investors are ignoring CEOs and finance ministers when they say everything is OK. Particularly when the prospect of more negative rates could further destabilise the banking industry.