The recovery of European and Spanish bank stock valuations

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The latest increase in EU bank stock valuations appears to be driven more by factors other than fundamentals. Expectations of a more favourable regulatory and interest rate climate have helped to provide some much needed breathing room to financial sector shares.

After the dismal valuations reached in mid-2016, European – and notably Spanish – bank stocks recovered significantly in the second half of 2016 and into 2017, bringing the price-to-book value close to parity. Paradoxically, the recovery in share prices coincided with the publication of a relatively uninspiring set of 2016 results by the main Spanish and European banks. This apparent contradiction is explained by two factors: the pick up in yield curves and expectations that regulatory pressure will ease.

Heterogeneous results

The publication of European banks' 2016 results (banks are now publishing their first quarter 2017 results) provides an opportunity to assess their performance, especially in light of a very significant recovery in the stock market value of nearly all European banks, especially Spanish banks.

The significant heterogeneity and volatility across banking systems (and between banks in the same system) is perhaps one of the most notable features of the 2016 results, as is the market's response to this volatility.

Among the four large euro area countries, only French banks reported a reasonable degree of homogeneity among large listed-banks, presenting a very similar set of results, both in terms of year-on-year growth and market expectations.

Sharp losses at Banco Popular had a negative impact on the overall performance of Spanish listed banks. Profit fell sharply on aggregate, but would have grown modestly excluding Popular.

However, heterogeneity was much greater in Italy and Germany. In Italy, the cleaner banks (Intensa San Paolo and Mediobanca) reported rising profits, but sharp losses recorded by Unicredit and Monte dei Paschi di Siena (MPS) pushed aggregate results for listed banks and the system as a whole into the red. Likewise in Germany, Deutsche Bank continued to post significant losses (albeit less than in 2015 when it undertook

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provisions of nearly 7 billion euros in order to cover a US Treasury fine of a similar magnitude), while Commerzbank's profit fell by 70%.

Paradoxical stock market recovery

The extraordinary heterogeneity between and within banking systems, with significant variation in both the amount and the profit/loss situation of banks, is leading to bank shares gaining a reputation for being highly volatile stocks in comparison to the rest of the market. Listed bank stocks rise more sharply when the overall market is on the up and fall more significantly when it is declining.

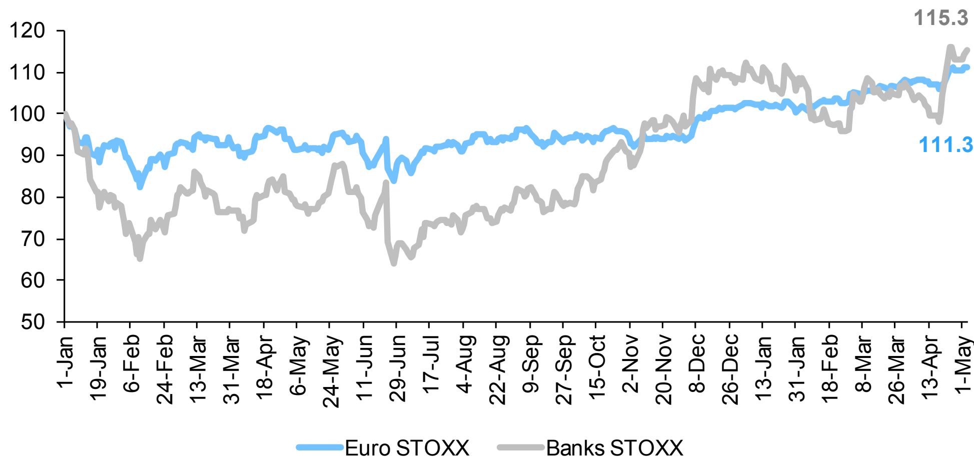
The performance of the stock exchange during the last year is particularly illustrative of the greater relative volatility of bank shares in Europe, as can be seen in Exhibit 1. The Exhibit shows the performance of the overall Eurostoxx index, compared with the banking sector component of the index. During the first half of 2016, European banks almost doubled the losses registered in the overall index, while in the last six months of the year the recovery was much stronger than for the overall index, with this trend being sustained into the first half of 2017.

The aggregate performance of European banks masks important differences between countries, both in terms of the initial decline in share prices, but especially in the recovery. Italian banks registered the strongest declines and they have yet to recover the bulk of losses during the first half of 2016, when renewed concerns began to emerge about the outstanding clean-up of their loan books. These doubts have not been resolved and have resulted in several of the large banks putting aside extraordinary provisions, which has led to losses in the system as a whole.

Meanwhile, German listed banks have recovered around half of the losses in the first half of 2016; having been particularly affected by the doubts surrounding Deutsche Bank.

Exhibit 1

Performance of Eurostoxx index compared to the banking component
(Base = 100: January 1st, 2016)



Source: Factset, AFI.

By contrast, Spanish and French bank stock have seen the strongest recoveries since the lows of last June. The relative value (Price/Book ratio) of Spain's four largest banks now stands at around parity. This is somewhat lower for Sabadell (0.75), while Banco Popular continues to have the weakest valuation at around 0.25 times book value.

Bank shares have been especially volatile in the last year, with Spanish and French banks registering the largest improvements in stock valuations.

Spain has seen the largest recovery in the stock market value of its banks, which also traded at a premium to European counterparts during the height of the crisis. Various factors explain this better relative performance. Firstly, the profitability ratios of Spanish banks are above that of other countries in the comparison. Furthermore, apart from Banco Popular, the bulk of the clean-up effort has already taken place (something which cannot be said, for example, in Italy).

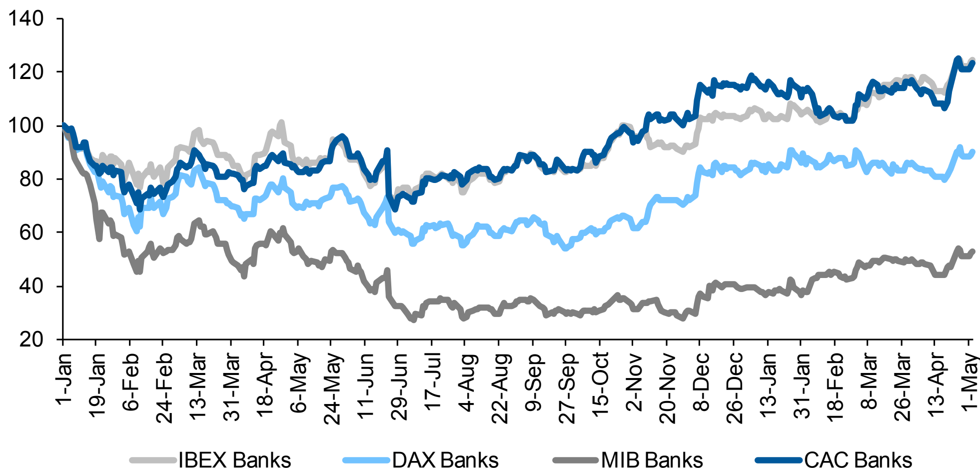
Likewise, the effort to recapitalise Spanish banks was significant, despite solvency ratios remaining somewhat below the EU average. Spanish banks are also set to be more sensitive to a pick up in interest rates than other countries' banks, with a larger proportion of the loan book referenced to variables rates (by contrast, fixed rates dominate in Germany). This means that as the normalisation

Spanish banks, with a large proportion of their loan book referenced to variables rates, will be in a strong position to rapidly increase their profitability as interest rate normalisation passes through to the interbank market.

of interest rates passes through to the interbank market, Spanish banks will be in a strong position to rapidly increase their profitability.

Exhibit 2

Performance of the main European banking indicators
(Base = 100: January 1st, 2016)



Source: Factset, AFI.

The same dispersion in relative valuations is present in other European banking sectors and is particularly notable in Italy, where Intesa-San Paolo is valued at 0.9 times book value, with Unicredit at 0.45 and MPS, the most problematic, trading at barely 0.06 times book value.

Reduction in systemic risk

In our opinion, the significant dispersion between bank valuations (which could be considered "positive discrimination") has a clearly positive interpretation insofar as conerns around sustainability (which is what a low P/BV ratio ultimately reflects) are no longer systemic, as was the case in mid-2016. Instead there is a clear differentiation between banks, essentially on two grounds. In terms of the degree of concern, firstly, around the need for additional asset clean-up and, secondly, banks' long-term capacity to generate sustainable net interest income.

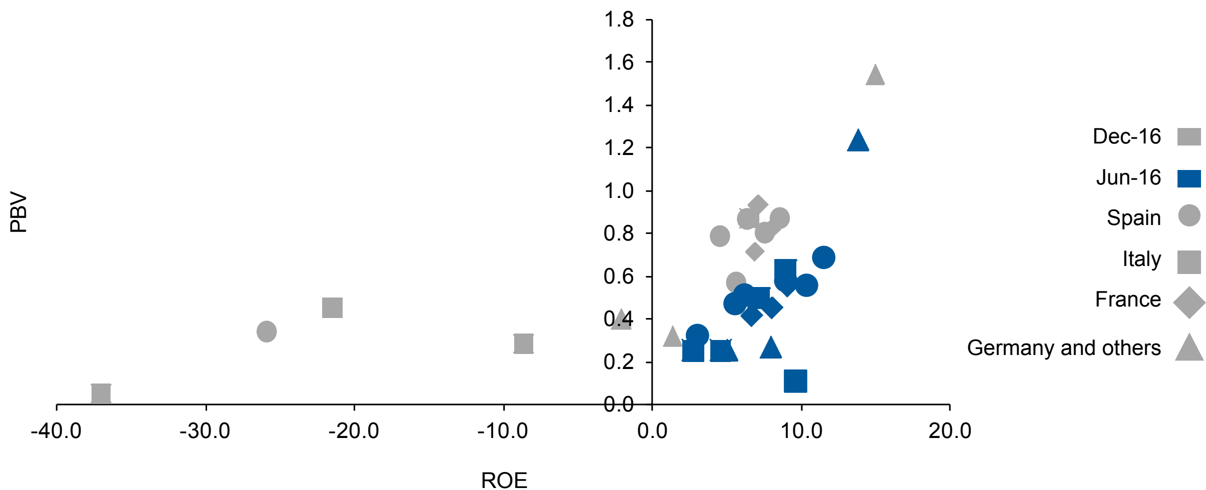
In order to lend credence to the idea of increasing market differentiation between banks, we have analysed two different points in time: mid-2016, when banks' stock market valuation hit a low point and the end of 2016, following a significant recovery in bank stocks. We correlated each bank's relative valuation (Price/Book ratio) with the return on equity (ROE) at both points in time.

The results presented in the following exhibit leave little room for doubt: valuation ratios were significantly higher at the end of 2016 than they were in the middle of the year, but most significantly, at the end of 2016, there was much greater dispersion in valuation ratios and a high correlation (around 60%) with each bank's ROE. This correlation was practically non-existent when valuations hit a trough last June.

However, it is also surprising in the sense that the pick up in bank stocks coincided with increased alarm about geopolitical risks in the second half of 2016. June's Brexit vote, Donald Trump's election in November and the Italian referendum have all led to heightened concern. The latter serving as an appetiser for this year's busy political agenda with

Exhibit 3

European banks: Relationship between valuation (P/BV) and profitability (ROE)



Source: SNL Financial, AFI.

elections having taken place in the Netherlands, the Presidential election in France and the upcoming German elections in the autumn.

Although it may seem counter-intuitive, it is highly likely that this convergence of political events may have had a significant influence on the strong recovery of European bank valuations. The line of argument is that these events, especially Brexit and Trump's election, have led to a reconsideration of two factors which have weighed on banks' profitability in recent years: (i) the burden of bank regulation; and, (ii) the low interest rate environment. Both the United Kingdom and United States look set to rein in the heavy burden of new regulatory demands on banks and associated uncertainties. The Bank of England's response to Brexit was to promise a clear relaxation of regulatory demands on British banks, meanwhile one of President Trump's first moves was to freeze, if not reverse, a significant part of the regulation associated with the Dodd-Frank Act.

Stock market valuation and the yield curve

These moves to relax regulation in the United Kingdom and United States, and the expectation that Europe could follow suit, have likely had a significant impact on the recovery in European bank stocks, especially as elements of political risk come into play given this year's European electoral calendar.

Another important implication of events in the United Kingdom and the United States is the more than probable change in the monetary-fiscal policy mix, which also likely played into bank valuations. Both countries appear to be taking a path towards a more expansive fiscal policy, taking some of the weight off exclusively monetary-based forms of stimulus and pointing to a possible normalisation of interest rates, which would undoubtedly be very favourable for European banking business.

The recovery in stock market valuation of European banks is based on expectations of a relaxation in regulatory demands driven by the United Kingdom and the United States, but above all by the pick up in the yield curve, pointing to a future normalisation of interest rates which would be crucial for the retail banking business.

However, the movements in bank shares not only reflect the implications of the election results. The euro area economy now looks to be moving towards more sustainable territory after several years of (conventional and unconventional) monetary policy stimulus, driving away risks of deflation and the danger of prolonged zero interest rates ("too low for too long"), which significantly would hamper the retail banking business.

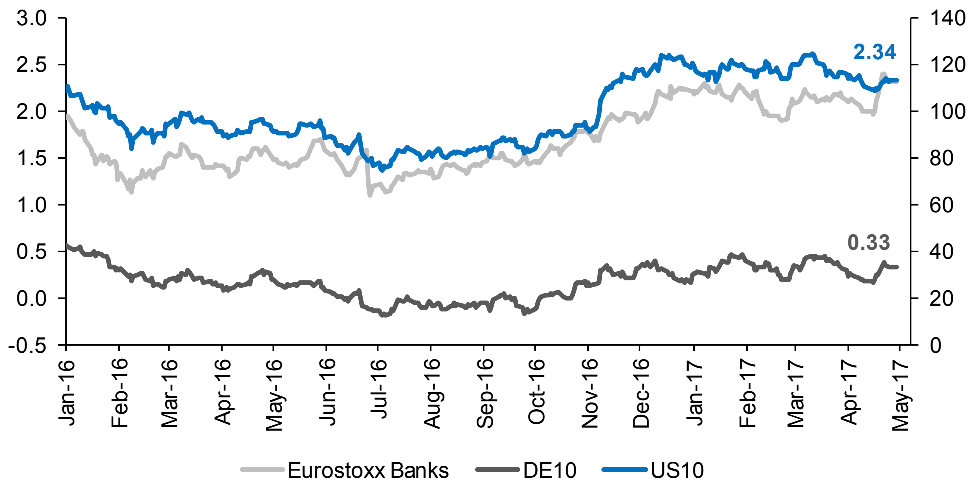
By way of illustrating this idea, we have analysed the correlation between European banking sector stock market valuations and indicators of future interest rate outlook, using both long-term US Treasury bonds and German bunds, as can be seen in Exhibit 4.

The correlation between the share price of Eurostoxx banks and 10-year German and U.S. Sovereign debt is clear, albeit significantly more pronounced for US Treasuries. A possible explanation for this is that the ECB's public debt purchases are "muddying" the ability of the long-end of the yield curve to anticipate future developments of short-term rates in the euro area; something which the U.S. yield curve can distil more clearly.

Furthermore, extending the analysis to include first quarter 2017 results, which have systematically

Exhibit 4

Performance of the banking component of Eurostoxx and yield on 10-year German and US bonds
(Base = 100: January 1st, 2016)



Sources: SNL Financial, Datastream, AFI.

beaten market expectations, further reinforces the previous analysis, given that the substantial improvement in bank fundamentals indicated by these results has not affected banks' share prices, which in turn suggests that the market is more sensitive to movements in the yield curve than banks' underlying performance.

Conclusions

The results leave little room for doubt regarding the significant impact of the pick up in long-term yields on European bank valuations, which is much more significant when compared to US Treasuries than it is for Bunds.

Beyond this statistical observation – the latter is the economic indicator with which the banking component of Eurostoxx is most closely correlated – the results are economically and financially rational. The T-Bond curve has been the first to capture a normalisation of interest rates and a move away from close to – or even below – zero territory, which has had such an adverse impact on the banking system.

This backdrop with a clear sensitivity of bank share prices to the yield curve, albeit with the tapering of ECB stimulus still some way off and likely to be gradual, suggests that the market is beginning to see light at the end of the tunnel for banks. A clearly improved macroeconomic outlook – as indicated by the latest indicators – facilitating a normalisation of interest rates, would give much needed breathing room to banks' battered income statements.

House prices and income: Trending in the same direction for now

María Romero and Noelia Fernández[1]

In the initial stages of post-crisis recovery, housing price growth has been matched by income growth. However, the lack of granular data and concerns over the maintenance of supportive factors, such as income levels and low interest rates, make it difficult to gauge the future outlook for the real estate sector.

After a sharp adjustment during the crisis, house prices started to grow in 2015 and are now accelerating. On average, at the national and provincial level, the increase in prices is being matched by an improvement in household income, reflecting their payment capacity. However, the lack of up-to-date data on income makes it difficult to confirm whether this also applies at a more micro level, such as districts of neighbourhoods within large cities. These are precisely the areas which have registered a larger increase in prices. In any event, future house price growth may be limited by subdued income growth and interest rate hikes, but the sector's ability to generate noteworthy returns on investment should help support house prices going forward.

House prices have started to grow again after the sharp adjustment during the real estate boom. The latest data even point to a slight acceleration in price growth, leading to potential concerns about the formation of a new housing "bubble".

Although house price growth is still modest and current levels remain far from pre-crisis peaks (still some 30% below), it is worth analysing the factors underpinning house price growth. Particularly, the extent to which current price increases in recent months are being matched by increases in the payment capacity of house buyers.

The fragmentation of the real estate market means that housing market developments need to be analysed at the highest level of granularity possible, given that the recovery in the sector seems to be focusing on specific regions (Taltavull, 2017). As a result, this article will aim to analyse house price behaviour and household income at the highest level of geographical disaggregation possible, which in turn will depend on the availability of statistical data.

It is also important to review the outlook for house prices over the coming months given that not only

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could this affect housing affordability for future buyers or returns for investors in these assets but also the country's overall financial stability.

Recent developments in house prices and drivers

Following the significant adjustment in house prices as result of the real estate crisis, housing is once again regaining value. In general, and across statistical sources, house prices began to grow in 2015, registering positive quarterly growth rates since then of between 0% and 2%. However, in year-on-year terms, price growth only exceeded the 1% threshold in 2016.

House prices registered a slight acceleration at the beginning of this year. The Tinsa IMIE Index, the first to be published, points to nearly 3% growth in the first quarter of 2017 (Exhibit 1). Likewise, the Centre for Sociological Research's (CIS) monthly barometer shows that an increasing proportion of citizens are expecting house prices to rise over the year based on their observations of the market. In February 2017 (latest available data), more than half of the survey respondents held this view, compared to 39% a year ago (Exhibit 2).

House prices continue to grow and even accelerated at the start of 2017, though they still remain a long way from pre-crisis peaks.

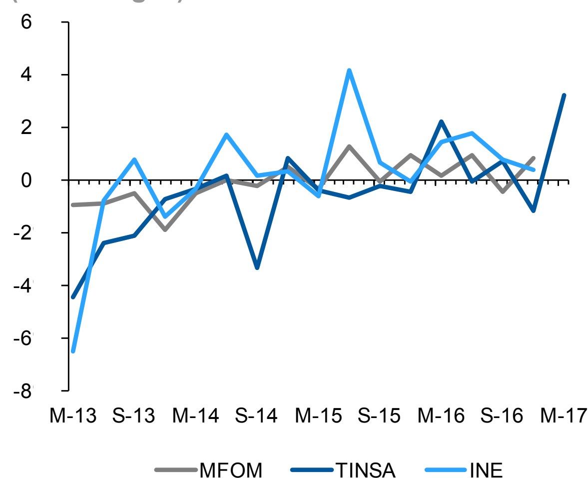
Even so, current house price levels remain a long way from pre-crisis peaks and even the most optimistic projections fail to see these being reached in the coming months. Either way, it is worth taking the time to analyse the factors that have driven house price growth so far.

House prices are explained by: (i) GDP, as an approximation of household income, which in turn reflects the payment capacity of the ultimate house buyers; and, (ii) the interest rate on mortgage loans, which reflects access to external financing (predominantly bank lending).

Exhibit 1

Quarterly change in house prices according to different statistical sources

(Percentages)

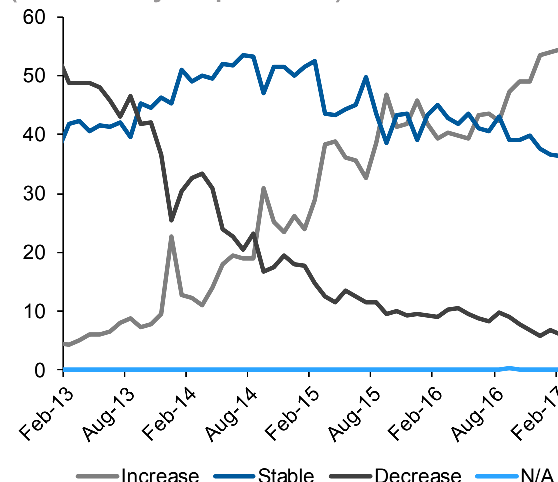


Sources: MFOM, TINSA, INE, AFI.

Exhibit 2

Assessment of house price developments in Spain over the coming year

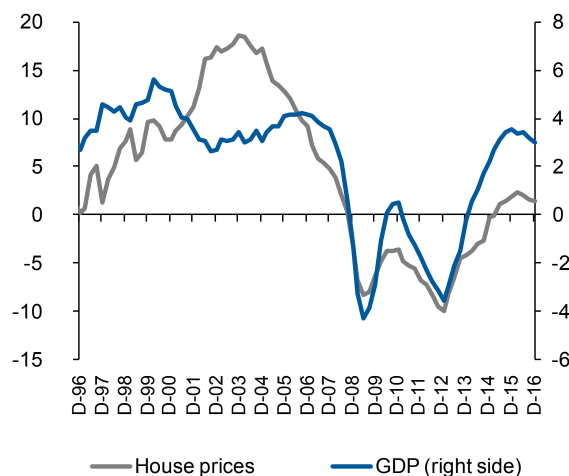
(% of survey respondents)



Source: CIS, AFI.

Exhibit 3

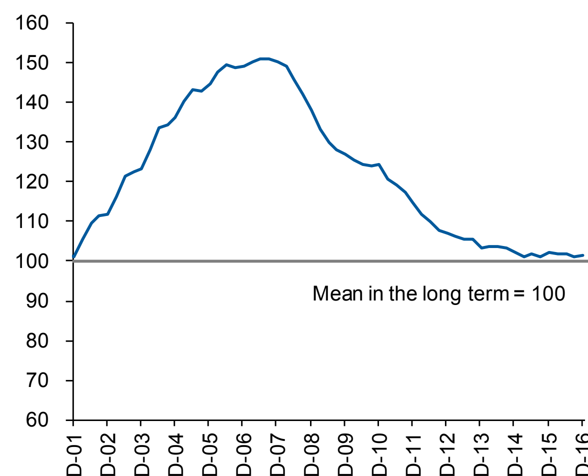
Year-on-year growth in house prices and GDP
(Percentages)



Sources: MFOM, INE, AFI.

Exhibit 4

Price-to-income ratio
(Base 100=Q101)



Sources: MFOM, INE, AFI.

In terms of GDP growth, house prices have moved in line with the increase in household income. This is underlined by the price-to-income ratio, which has been at its long-term equilibrium since the start of 2015 (Exhibit 4). Therefore, to date at the national level, house price growth has been matched by income growth.

However, the fragmentation of the real estate market means it is important to replicate this analysis at the highest level of granularity possible, given that the national average could be masking disparities between house prices and household income.

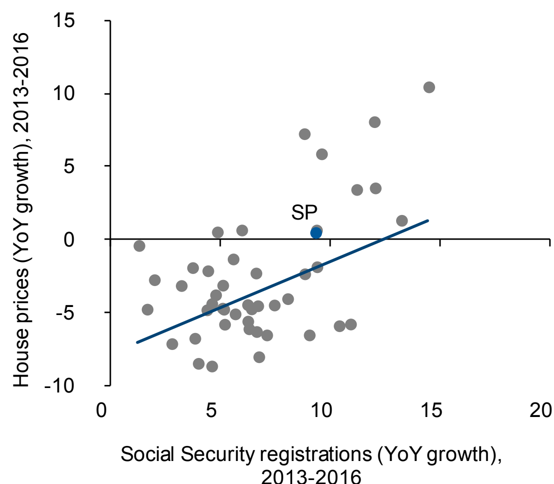
The different territorial reality

The first major breakdown available from official statistics after regional level data is at the provincial level. An analysis of provincial data suggests that house price growth has also been matched by income growth. The provinces which have seen the largest growth in house prices over the last three years are also those which have seen the biggest increases in employment (Exhibit 5) and, therefore, income or final house buyer payment capacity, which is also illustrated by the pick-up in housing transactions in these provinces. The Balearic Islands and Barcelona stand out particularly in this regard.

Municipal data offers another perspective, although statistics are limited to large cities, *i.e.* municipalities with more than 25,000 inhabitants. The cities where growth has been most dynamic and employment creation capacity the strongest are also those which have been the most successful in attracting inward migration, with higher demand for housing and upward pressure on house prices. However, it is also true that there are some signs of increased pressure on house prices in specific coastal regions where demand for second homes, especially from foreigners, is stronger – with demand focused on above average value housing.

Exhibit 5

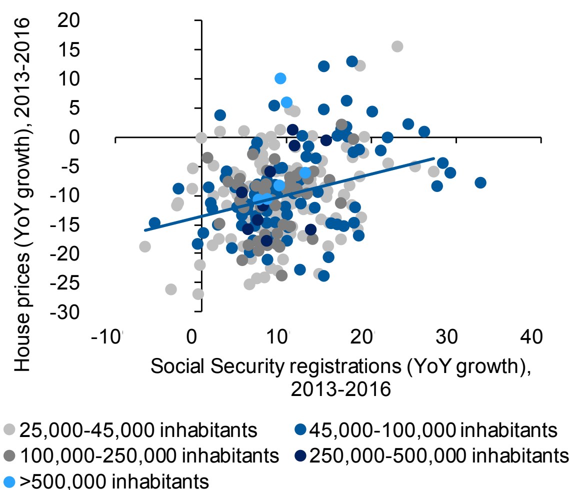
Growth in Social Security registrations and house prices by province
(Percentages)



Sources: MFOM, MEYSS, AFI.

Exhibit 6

Growth in Social Security registrations and house prices by cities with more than 25,000 inhabitants
(Percentages)



Sources: MFOM, MEYSS, AFI.

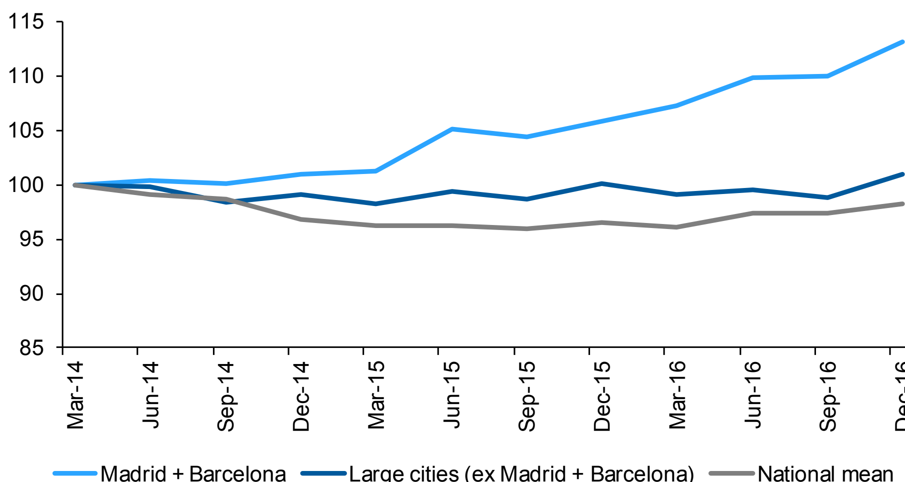
But without a doubt, the most significant increases in house prices have taken place in Spain's largest cities, Madrid and Barcelona and their respective metropolitan areas. Since the start of the economic recovery (2014) up to the end of 2016, both cities have registered cumulative increases in house price values in excess of 13%, while the average for cities with populations of over 25,000 has remained practically unchanged since then (Exhibit 7). It is worth bearing in mind two factors that could have affected price developments in these two large cities. The first is related to the increase in the proportion of transactions and therefore used-house price valuations. These types of dwellings are generally located in city centres, where prices have risen more strongly, in addition to the fact the price level is generally above new housing. In fact, the most central districts, which have the highest price levels, are exactly those which have registered the largest increases in house prices in recent years. The second factor is related to the renewal of city centres, the significant provision of infrastructures and services on offer and the increase in demand for rentals, all of which have created greater investor appetite in these areas.

So far, house price growth has been matched by national and provincial payment capacity, but it is not possible to confirm whether the same is true for specific cities.

The key question is therefore up to what point the increase in house prices is also related to an improvement in ultimate house buyers' payment capacity. Analysing house price developments in 2015 (latest data available) and household income in each of the districts in these two large cities, suggests that the ratio between the two is generally at its long-term equilibrium (Exhibits 8 and 9). However, there are some districts where there is a degree of disconnect between house prices and household income developments. In particular, there are signs of an over valuation of central districts and undervaluation of outlying

Exhibit 7

Growth in house prices
(Index base 100=Q114)

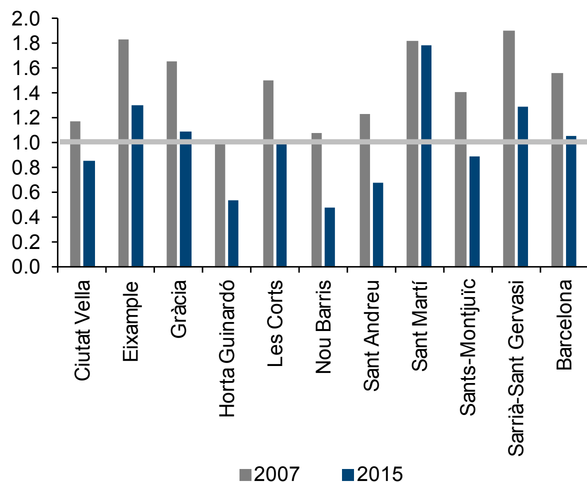


Source: MFOM, AFI.

areas. Furthermore, in the absence of statistical data on household income in each district in 2016, which is when prices grew most strongly, it is impossible to know whether growth in house prices has been matched by income or not. Therefore, it is not possible to say whether prices are growing at the same rate as the payment capacity of ultimate house buyers.

Exhibit 8

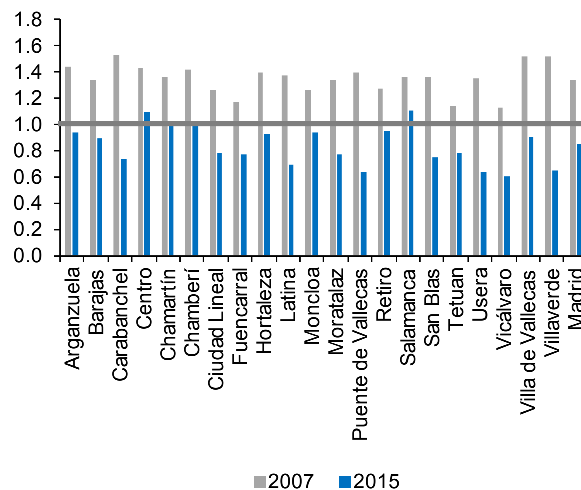
Price-to-income ratio in districts of Barcelona
(Base 100=2002)



Source: Barcelona town hall, Idealista and AFI.

Exhibit 9

Price-to-income ratio in districts of Madrid
(Base 100=2002)



Source: Madrid town hall, Idealista and AFI.

Outlook

The outlook for prices is particularly relevant insofar as it not only affects housing affordability for final purchasers or returns for investors in these assets, but also the country's financial stability.

Consensus forecasts a slowdown in household income growth together with an expected increase in interest rates on mortgage loans, both of which will limit house buyer's external financing capacity and will contain house price growth.

Projected subdued future income growth, together with the expected increase in interest rates, will limit house price growth.

Either way, and despite the expected slowdown in house price growth, housing will continue to offer returns well in excess of other financial assets (currently over 4.4% according to the Bank of Spain), which could strengthen investment in the residential sector and put upward pressure on prices over the coming months.

Conclusions

Following the significant adjustment during the crisis, house prices started to grow in 2015, registering growth of over 1% in 2016. The pick-up in growth at the start of 2017 could foreshadow the emergence of a new real estate "bubble", if it is not accompanied by concurrent increases in household income. The fragmentation of the real estate market means detailed micro-level analysis at the territorial level is required. Thus, while growth in house prices has been matched by income at the national and provincial level, the absence of statistical information at the most granular territorial level, such as districts within largest cities (Madrid and Barcelona), makes it difficult to confirm whether the same is true for these areas.

References

Taltavull, P. (2017), "Spain's real estate sector: Slow path to recovery and future outlook," *Spanish Economic and Financial Outlook, February 2017.*