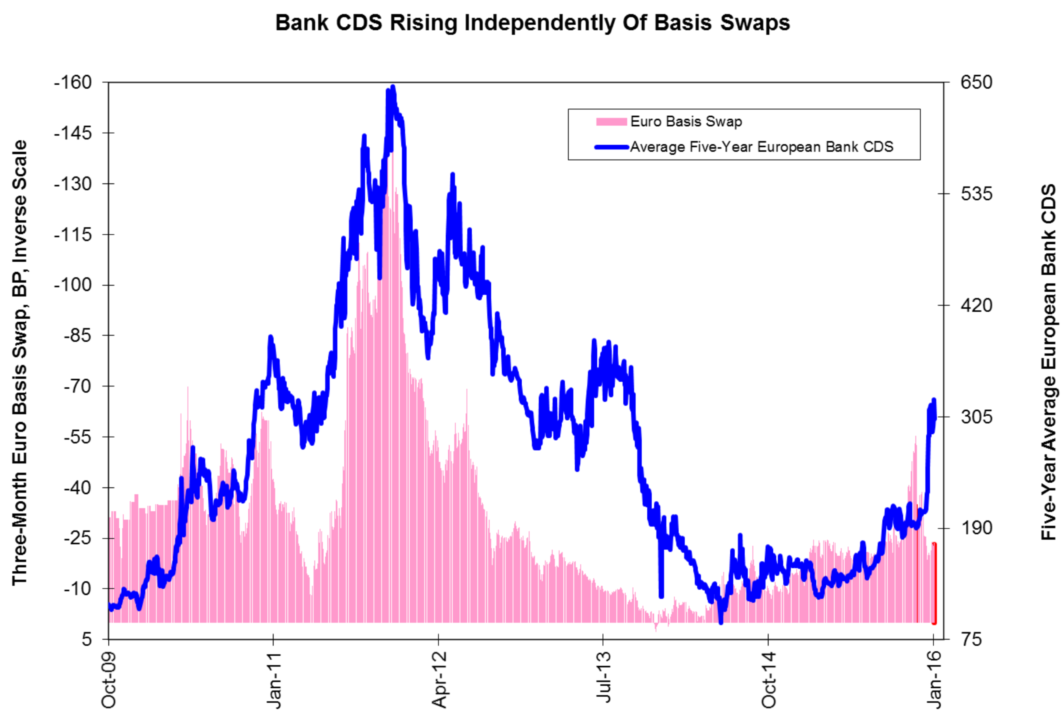
European Commercial Bank Stress Drives ECB Policy

The only reason I cannot remember the onset of the various Eurozone sovereign debt crises like they were yesterday is the whole thing started to unfold on October 19, 2009, or more than six years ago. The typical pattern since then has been for the average of five-year bank credit default swap (CDS) costs to rise and fall as three-month euro basis swaps, or differences between euro and dollar short-term rates, widen and narrow, respectively. Indeed, the largest decline in bank CDS costs came after euro basis swaps narrowed following the expansion of global currency swap lines in November 2011; this relieved stress on commercial banks with USD liabilities.

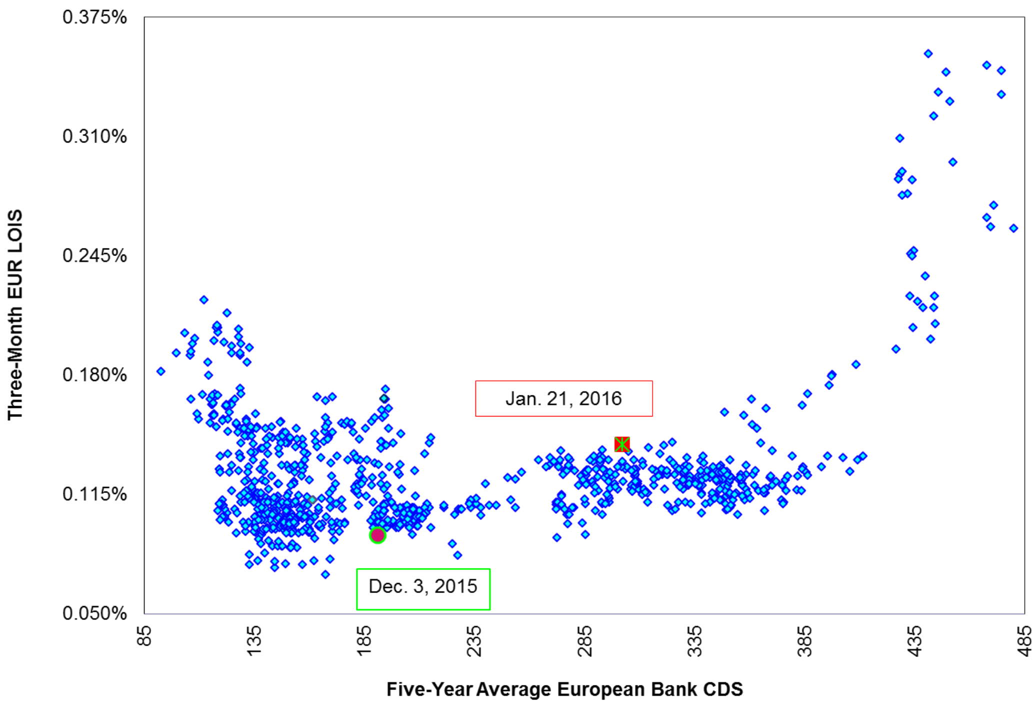
The pattern changed when the European Central Bank did not ease as aggressively as expected in December 2015. Basis swaps increased back to levels prevailing prior to the ECB's October 2015 hint it would ease more aggressively, a simple and singular repricing of conditions. However, bank CDS costs started to move higher rapidly.



This increase in bank CDS costs has been related only weakly to the EUR LOIS spread between Euribor and EONIA, or the euro overnight index rate. Eurozone banks remain heavily over-reserved and Euribor has moved to record-low levels. Banks are continuing to pay to lend to each other as opposed to paying the penalty for depositing excess reserves at the European Central Bank. I would quip, "Is this a great country, or what?" but the Eurozone is a collection of treaty unions linked by a common monetary policy and suffocating under multiple dense bureaucracies in Brussels. Why the British ever would contemplate leaving the European Union is beyond me.

Let's map EUR LOIS against bank CDS levels from the July 2012 "whatever it takes" statement onwards and mark both the December 3, 2015 and January 21, 2016 ECB statements. Three-month EUR LOIS expanded 4.9 basis points while average five-year bank CDS costs expanded by 111.48 basis points, or more than 58.3%.

Bank CDS Costs Surged After December 2015 ECB Decision



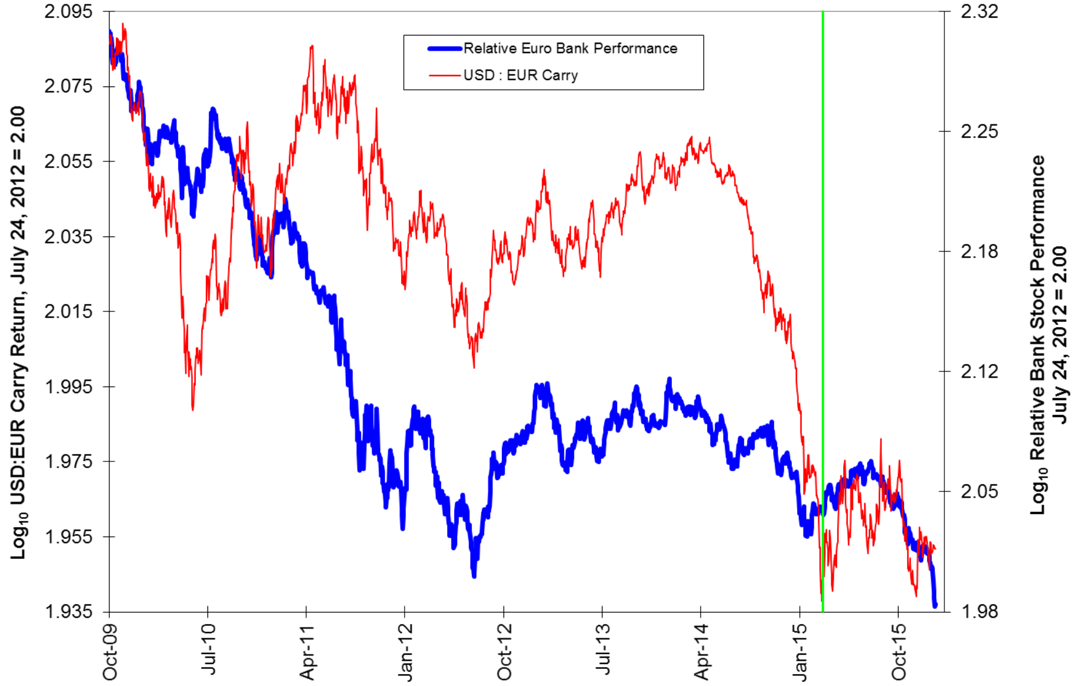
Relative Bank Stock Performance

The relative performance of the STOXX Europe 600 bank index vis-à-vis the STOXX 600 price index has been declining sharply since the August 2015 devaluation of the Chinese yuan, and this decline in relative performance only accelerated with the CNY's declines this month. Even before the August 2015 downturn, the USD:EUR carry return linked to relative bank equity performance. This is similar to a U.S. pattern where monetary policy expectations are driven by the health of the financial sector and not the other way around.

Restated, currency traders were willing to end the EUR's decline shortly after the launch of Eurozone QE (green vertical line) in the belief it would lead to a stronger banking sector and hence to a less-aggressive ECB. That expectation ended in August 2015 and after the December 3, 2015-January 21, 2016 pause, currency markets once again will have to price in a more aggressive ECB policy designed to relieve commercial bank stress.

Consistent with the above, we should see three-month euro basis swaps decline to more negative levels unless the Federal Reserve signals a reversal of its December rate hike. I would not stay up too late waiting for that to happen as central banks are not given to admissions of error, are they?

EUR Linking To Eurozone Bank Relative Performance In QE Era



Bank Stock Underperformance Continued As Basis Swap Narrowed