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**Subject:** EU BANKS: BIG EQUITY OUTFLOWS BUT REMAIN UPBEAT ON REFLATION TRADE: SALES TOP PICKS = SOC GEN, INTESA, NORDEA

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### **EU BANKS: BIG EQUITY OUTFLOWS BUT REMAIN UPBEAT ON REFLATION TRADE**

#### **Spec Sales Comment:**

#### **Big Equity outflows but we see this is a pause not a reversal**

BofAML latest flow show data this morning shows the largest equity outflows in 40 weeks and first outflows YTD (click [here](#)). Our BofAML Bull & Bear Indicator is now at 7.1, the highest level since Jul'14 and not far from "sell" signal. So is this just a pause for breath in the reflation trade? BofAML strategists think so. In our updated thoughts this morning we think reflation is real so stay long equities, short rates, selectively long USD (click [here](#)).

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#### **Why do we remain bullish the reflation trade?**

The main reasons for equity investor concern in recent weeks = the gap between hard and soft data, plus the delay in the Trump fiscal package

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We continue to believe in the reflation theme because:

1. **Strength in the global economy is genuine** - European PMIs are at 6 year highs, Chinese and Japanese PMIs continue to improve too. In fact ~90% of PMIs globally are above 50 and 60% have increased in the last 3 months.
2. **Earnings revisions and Global Wave point to continued upturn** - earnings revisions now above 1.0 for the first time since 2011.
3. **We expect Trump to deliver on tax, even if it is smaller than hoped for** - should such a package be put together it would likely support the Trump trade once again after the failure to reform Obamacare
4. **Bond markets are being too sanguine about the likely pace of Fed tightening** - the Fed funds curve is once again well below the dot plot. We continue to see upside in yields if and when the market becomes more convinced that the soft data is right.

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#### European Banks holding up better than US Peers on pull back

In Banks, the reoccurring feedback from investors has been that clients have rotated out of US banks and into European banks. This conflicts with our latest Fund Manager Survey which suggested allocation to European Banks fell the most of any sector MoM in the first two weeks of March, however, its true European Banks have quickly reversed the performance gap to US peers. The spread between the SX7E and S5BANKX Index is back to pre-US election levels.

#### What the EU banks bulls are saying:

EUR rates are going higher it's just a matter of timing, positive EPS revisions continue, EU is starting to see pockets of volume growth and asset yield recovery, credit spreads have been tightening YTD and attractive valuations of EU banks vs. US peers (EU banks on 12.0x 2017E P/E vs. US Banks on ~14x and some EU banks still on a large discount vs 10-year historical median P/B valuations).

#### What the EU banks bears are saying:

EU macro declining, US lead re-flation trade cooling (tax, deregulation, healthcare headwinds) and topy multiples/high ownership of EU banks going into Q1 results. They believe the pressure will be off Draghi to act on the deposit rate if the macro starts to reverse which may cause people to push back the assumed timing of European rate hikes and tapering. The French election is also a big risk factor which is clearly holding back some global investors from buying into Europe.

#### Rates Update

Consensus has started to factor in the higher rate outlook in Europe. The bears are pointing out that these probabilities have fallen a lot this week while the bulls argue it's just a matter of timing.

I monitor market expectations for ECB normalisation in rates using the World Interest Rate Probability (WIRP) function on Bloomberg. It's been very volatile recently. I currently see the market is pricing a 16.6% probability of a EUR rate hike before the

end of 2017 (row 6, column 2 below). a 32.7% probability in the next 12 months (row 9, column 2) and a 67.6% probability in the next 18 months.

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As a reminder our research team estimate that euro area banks could see as much as €26bn in earnings uplift from a return of ECB rates to zero. This would represent a 25% uplift to profits - a big prize when it happens (click [here](#) for report).

#### **What to buy in banks if you share our view on sustained deflation?**

We remain positive on banks that can make acceptable returns in the current environment and are geared into the upside when rates begin to recover... **ING, KBC, Intesa, Unicredit, SocGen, Erste, BKIR are all Buy rated.**

Top picks:

#### **Buy Soc Gen, PO C55**

- Still fourth worst performer in the SX7E YTD due to French election overhang.
- Yet reported a strong set of Q4 results, beating on P&L, capital and dividend which comforts our view that the stock is set for re-rating.
- Continues to tick a number of boxes offering a dividend yield of 5.1% in 2017E, an attractive valuation of 0.79x 2017e TNAV, solid capital position and has strong EPS momentum.
- Our EPS (2017 and 2018) is 10% above consensus with further upside from CIB, Russia recovery and Corporate Center
- Stronger capital position allows for growth (organic and bolt-on M&A)

#### **Buy Intesa, PO C2.80**

- On NPEs, capital, profitability, operating trends, and cash payouts, Intesa stands above other Italian banks in our view.
- ISP will pay a dividend (confirmed) equivalent to an 8.0% yield vs. a 4.0% European banks average and on our estimates
- Italian banks are trading at a PNAV discount to ISP but their profitability is half that of ISP's and their capital is lower
- ISP retains the lowest (gross/net) Italian NPE ratio and in 4Q16 NPE were down yoy by 8% gross/10% net.
- Shares have suffered from the uncertainty related to a possible tie-up with insurer Generali - still the seventh worst performing bank in the SX7E YTD

#### **Also remain very bullish on market exposed Nordic banks**

This morning we reiterate our preference for Nordic banks (click [here](#) for report) with more market exposed revenues and reiterate our **Buy ratings on Danske Bank, Nordea, DNB and SEB** ahead of Q1 results. We expect to see good fee /trading income in Q1 on the back of strong AUM and continued high activity levels.

The relative P/E premium of Nordic banks vs. the sector is now 7% vs. a long term average of 11%. We also note that Nordic banks are expected to continue to deliver close to 4% better ROTE (2017-19E) and have a lower beta.

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**Please let me know if you would like to discuss in more detail or meet any of our analysts on the above reports.**

Kind regards,

**Russell Quelch**  
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