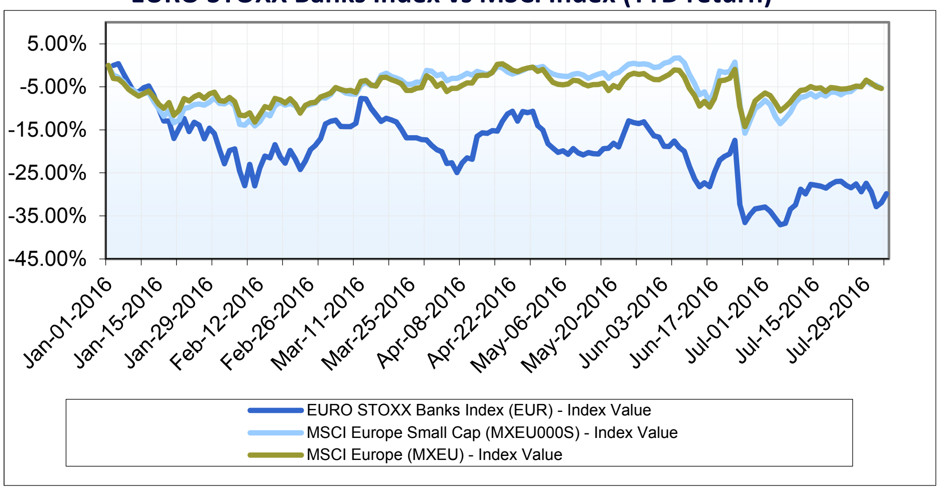
COMMENTARY

August 5, 2016

Dear clients and colleagues,

The European Financial sector has been the worst performing sector year to date. Within Financials, the banking industry has suffered substantial decline over the same period. While the banking industry offers a significant valuation discount, a challenging environment and the ongoing regulatory risk remain a major source of uncertainty.

EURO STOXX Banks Index vs MSCI Index (YTD return)



Source: MSCI, Capital IQ

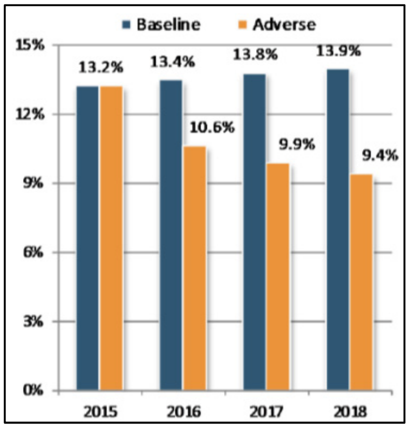
Bank stress tests

In last week's stress tests, the European banks were subject to a hypothetical negative macroeconomic scenario for the period of 2016 - 2018 in which EU real GDP growth rates were assumed to be -1.2%, -1.3% and 0.7%. In looking at the current ECB GDP growth estimates (1.5%, 1.4% and 1.6%), we notice the large gap between the two.

The tests were applied to 51 banks which account for 70% of Europe's banking sector. Banks in the euro area, Denmark, Norway and the UK were included while Portuguese and Greek banks were excluded because of their size.

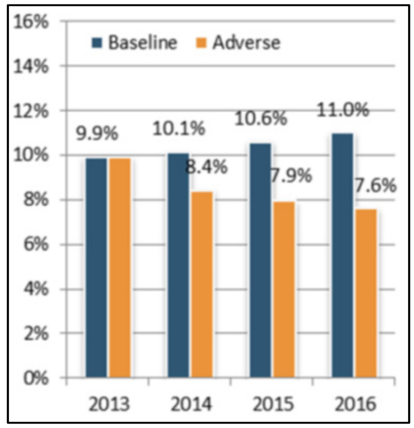
Overall, the results of the latest stress tests demonstrate the resilience of the EU banking sector. As demonstrated below, European banks' capital position fared materially better under the adverse scenario compared with the 2014 stress tests. The decrease in solvency in the 2016 tests is steeper than in the 2014 tests as the Common Equity Tier 1 ratio (CET1) shows a decline of 340bps (from 13.2% to 9.4%) versus 230bps. It is worth mentioning that even under these adverse scenarios, banks are expected to generate profit in the near future.

2016 Stress test results



Source: EBA

2014 Stress test results



Source: EBA

An analysis of the results by country shows that Irish banks (Bank of Ireland, Allied Irish Bank) and Italian banks (Unicredit, Banca Monte dei Paschi di Siena) are among the weakest performers. If we were to apply a 5.5% CET1 capital ratio threshold, only 2 out of 51 banks would have failed the tests (Allied Irish Bank, Banca Monte dei Paschi di Siena).

We believe that the risk of a capital increase only concerns a few banks. The regulators will probably use the stress test results as a means to request a change to their capital plan or set a capital requirement for each individual bank. An additional capital buffer would certainly be needed to address the large stock of non-performing loans (NPL) within the Italian banking industry.

We believe the banking industry is likely to remain under pressure mainly because of poor visibility. Since the beginning of the year, our underweight positions within the banking industry have had a positive impact of 90 bps in our International portfolio.

Have a good weekend.

The Global Alpha Team