The Turkish Hamam Is Getting Too Hot For European Banks. Avoid The Bazaar!

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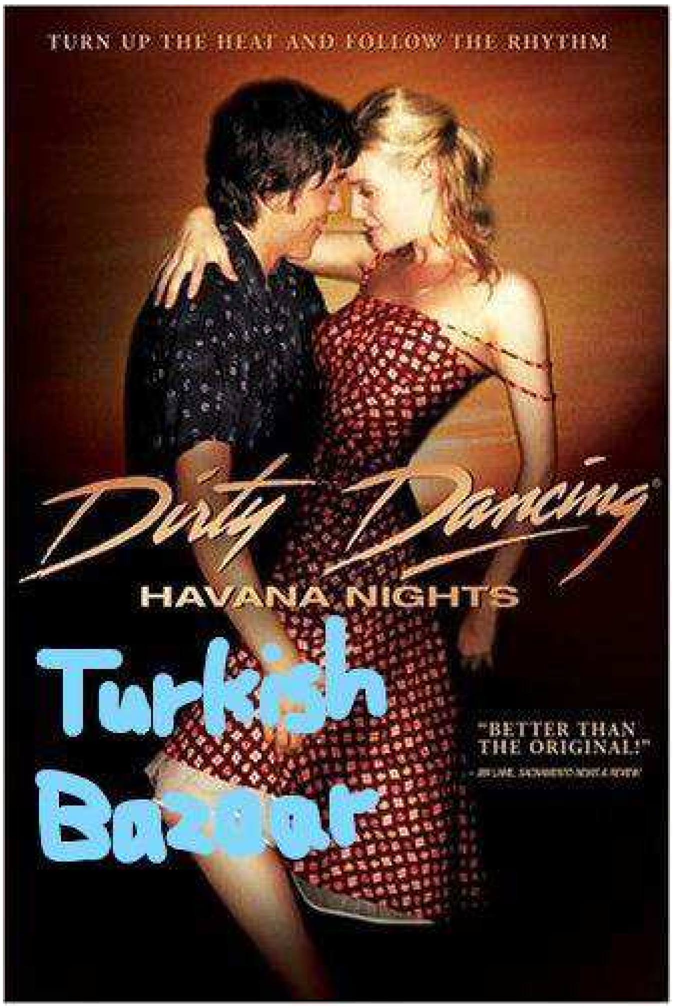
by: The Fortune Teller

Summary

- Forty days ago we wrote about the impact that the slowing Brazilian economy has on Spanish banks.
- We warned about investing in the two largest Spanish banks, Banco Santander (SAN) and BBVA (BBVA), mainly due to Latin America accounting for 46% of revenues.
- We also mentioned these banks exposure to Turkey as being a major problem. Very quickly this warning turned very valid.
- It now seems like the secondary concern has turned into a primary concern. Beware and don't say you haven't been warned!
- *Members of my private investing community, The Wheel of FORTUNE, receive real-time trade alerts on this idea and many more. Learn more today >>*



Background

It was only five weeks ago, when we wrote an article about Spain (EWP) and its two largest banks - Banco Santander (SAN) and BBVA (BBVA) - being too much exposed to the Brazilian (EWZ) struggling economy. T wit:

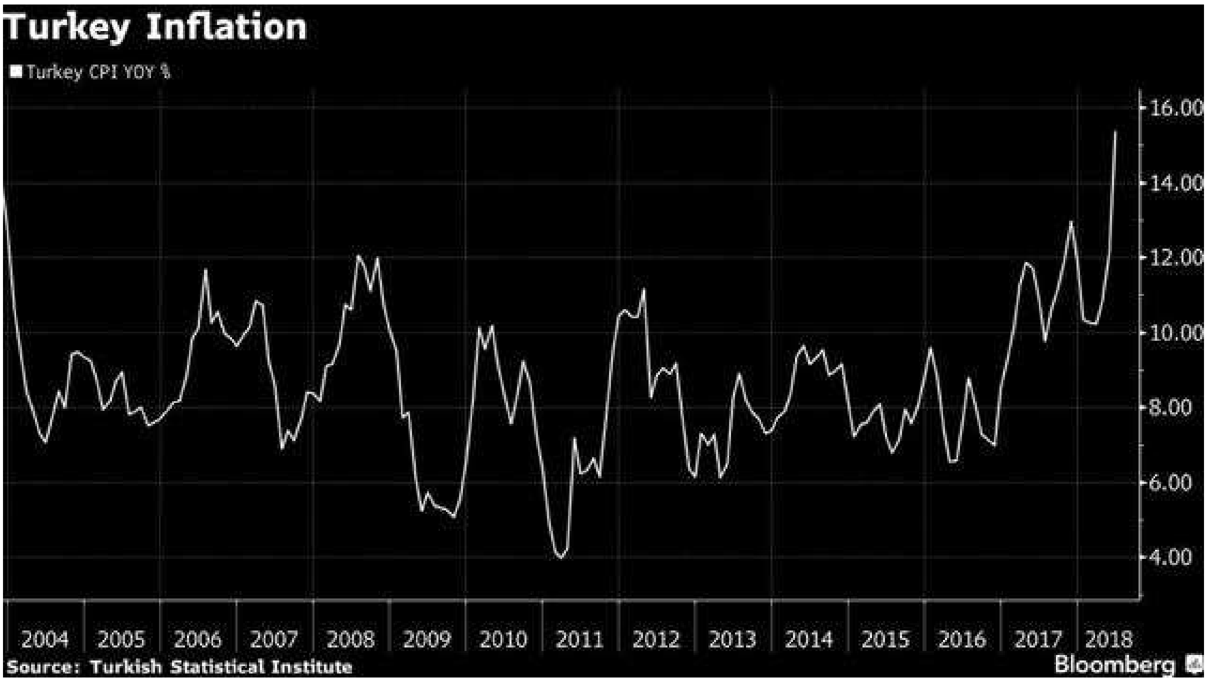
> *Latin America accounts for 46% of the revenues of the two largest Spanish banks, Banco Santander (SAN) and BBVA (BBVA).*

Here is the bottom line of that article dated July 4th 2018:

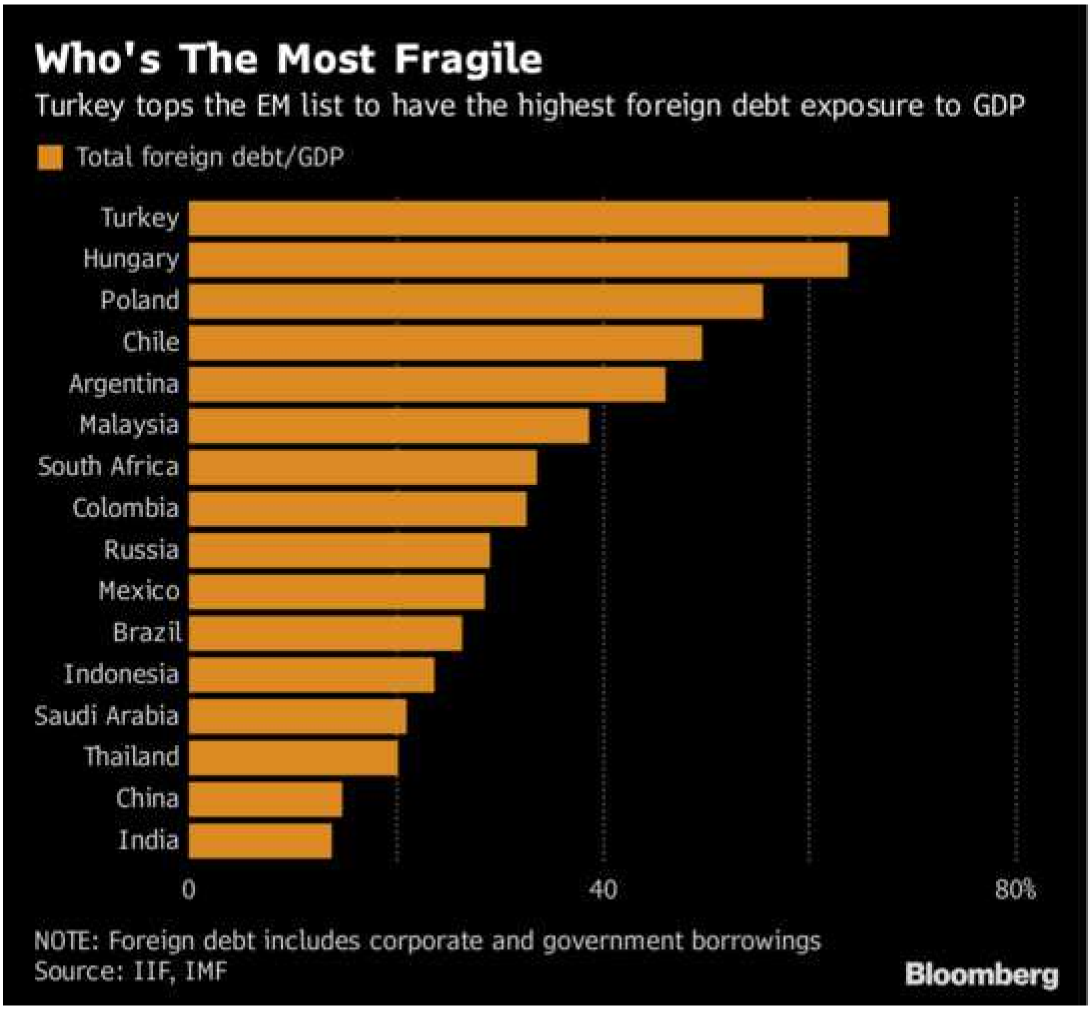
> These are rough times for Brazil, Turkey (TUR) and the ECB/EU. Consequently, those are rough times for Spain too.
>
> It's more than just acknowledging that the US rule the world. It's about many internal Spanish and European issues as well as the European credit market(and consequently banking system) that are completely distorted, as my recent articles suggest.
>
> Deutsche Bank (DB) is an example for a European bank that suffer from certain problems, mostly related to its investment banking expansion on one hand and US aspirations on the other hand.
>
> Contrary to that, Banco Santander and BBVA issues have nothing to do with investment banking and/or the US. Instead they have a lot do with geographical exposure and economic cycles.
>
> Emerging markets are the best place to be in when the world economy is in the middle of an expansion mode towards peaking. They are the worst place to be invested in when the world economy is slowing towards bottoming.
>
> I'm not going to suggest where we are now when it comes to the economic cycle but it certainly doesn't look promising for Brazil and/or Turkey.
>
> And if these two countries are heading in the wrong direction - it's likely for Spain, Banco Santander and BBVA to follow through.

In regard to Turkey we mentioned the following:

It's important to also note the exposure that these two banks have to Turkey (TUR), another country that isn't in good shape, to say the least. Inflation in Turkey just hit 15.4%, an almost 15-year high, and the Turkish Lira can't put an end to its slide.



With Brazil on one side and Turkey on the other side, it seems very likely that serious problems in Spain are about to emerge soon.



Where Problems Started

Some people may erroneously think that it all started with yet another one of Donald Trump's destructive/constructive (depends on the beholder eyes) tweets.

On Friday morning, the US president used Twitter (TWTR) to express his dissatisfaction with the US and a Turkish delegation unable to make progress on negotiations to free detained US pastor Andrew Brunson, who is being held in Turkey under accusations of supporting a coup.

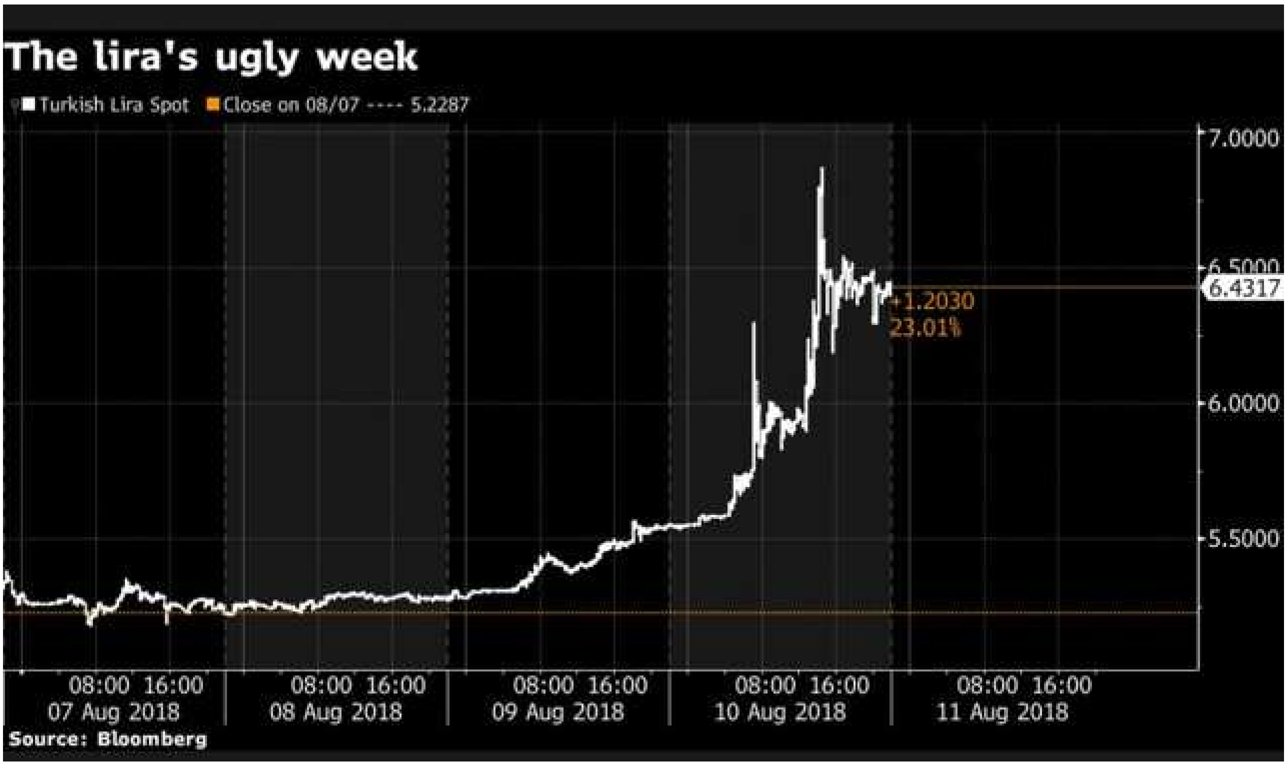
True, this has clearly intensified things up. However, the Turkey bath - aka "Hamam" (side note: highly recommended!) - has started over-heating quite some time ago, as evident by both my article and the charts (hereinafter). It should be clear that the US sanctions are certainly not the only thing hurting the Turkish economy.

Investors are worried about Recep Tayyip Erdogan, the Turkish President's unorthodox economic views and appointments that are nothing but pure nepotism. For example, Erdogan said that higher interest rates lead to higher inflation, the opposite of what standard economic theory states. As a result he's pushed Turkey's central bank - which he now de-facto controls - to keep interest rates low and, by doing so, not only threatening its independence but also handcuffing the hands of those who are left to maintain a sane monetary policy.

The Turkish President - who (in some ways) resemble Trump himself in being impulsive, quick to pull the trigger and unhappy when things don't move his way - was quick to urge the Turkish people to step in and help the (still officially secular) republic by buying the local currency.

> *Change the euros, the dollars and the gold that you are keeping beneath your pillows into lira at our banks ... This is a domestic and national struggle.*

As a result of the heavyweight battle (though not anywhere to being same weights...) the Turkish Lira, aka TRY, tumbled no less than 20% against the greenback:



The TRY is now down 36% YTD against the USD. The weakening Turkish Lira has been pushing up the cost of goods for Turkish people on one hand and shaken international investors' confidence in the country on the other hand.

However, the effects haven't been felt in Turkey alone. The escalating tension has saw both the Turkish and the US stock markets taking a hit last Friday. The iShares MSCI Turkey Investable Market Index Fund (TUR) plummeted 14.53% - after falling as much as 21.6% at some point - and is now down 50.7% YTD. The SPDR S&P 500 ETF Trust (SPY) declined only 0.67% and is still up 6.1% overall in 2018.

SPY data by YCharts

The effects of the dispute haven't been felt only at the equity market. Bonds prices, especially high grade rated, rose. The yield on the 10-year Treasury note fell to 2.89% from 2.93%. That, for itself, helped send US bank stocks lower: JPMorgan Chase (JPM) slid 1.7%, Bank of America (BAC) gave up 2% percent and Citigroup (C) retreated 2.8%.

Naturally, the Turkish effect was felt mostly across the Atlantic with the European main markets all seeing a deep-red day:

- Germany's (EWG) DAX down 1.99%
- UK's (EWU) FTSE 100 down 0.97%
- France's (EWQ) CAC down 1.59%
- Italy's (EWI) FTSE MIB down 2.51%
- Spain's (EWP) IBEX down 1.56%

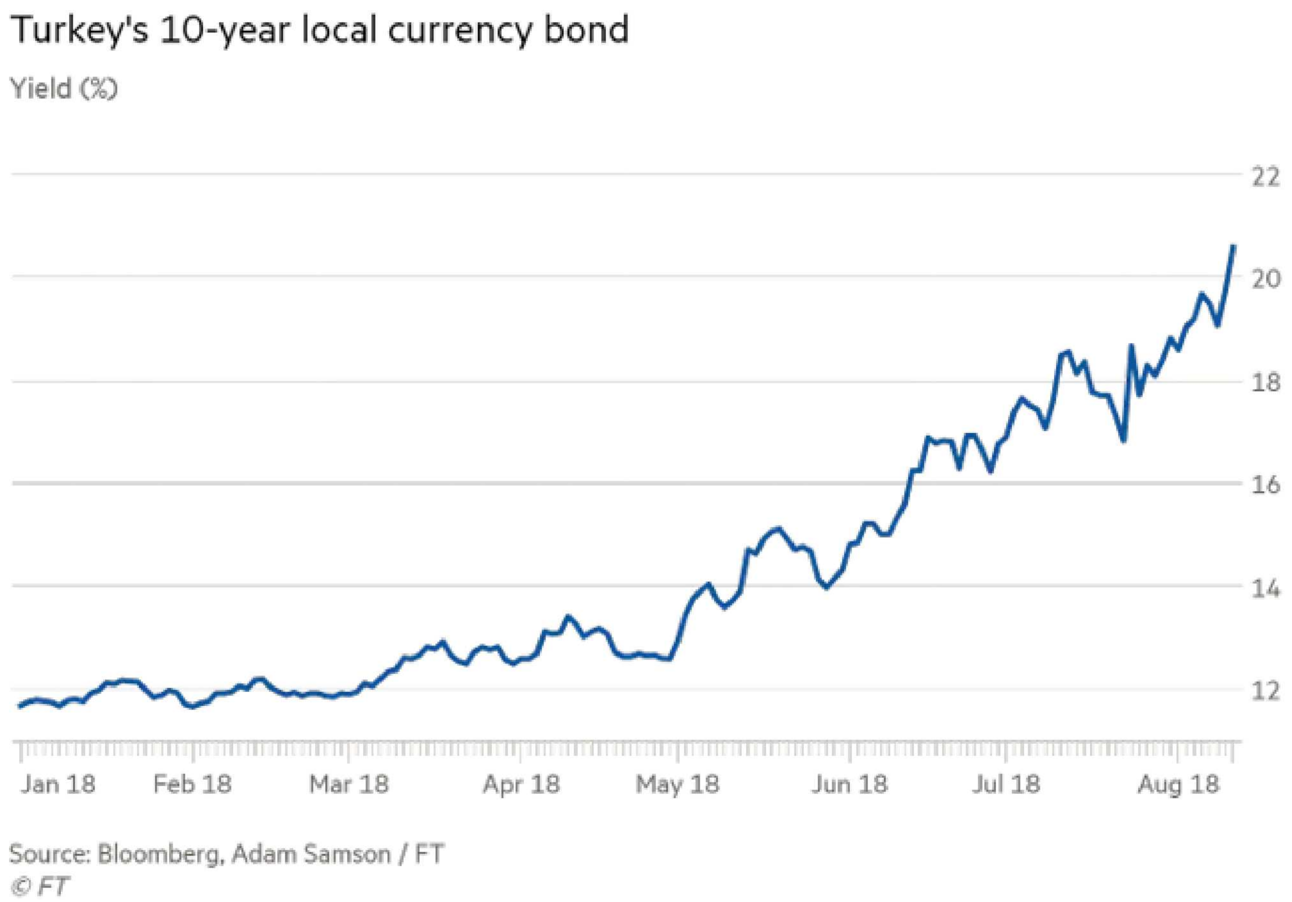
Closer Look at Relevant Data

Aside of the local currency, investors should also pay attention to the following nothing-short-of-stunning indicators. As the Lira collapses, yields on Turksh debts are rising.

- **The yield on Turkish 2-year treasury debt is now over 25%**

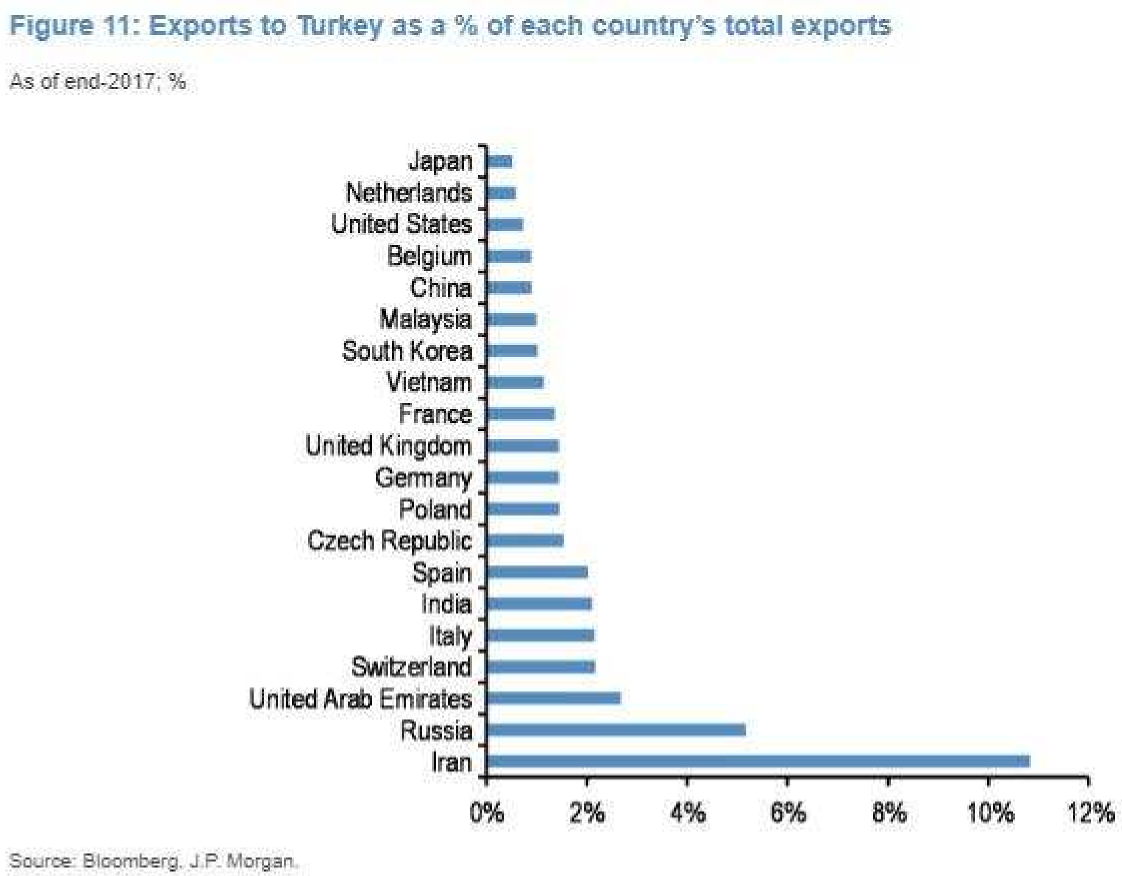
Alternatively, one may elect to look at the benchmark 10-year yield.

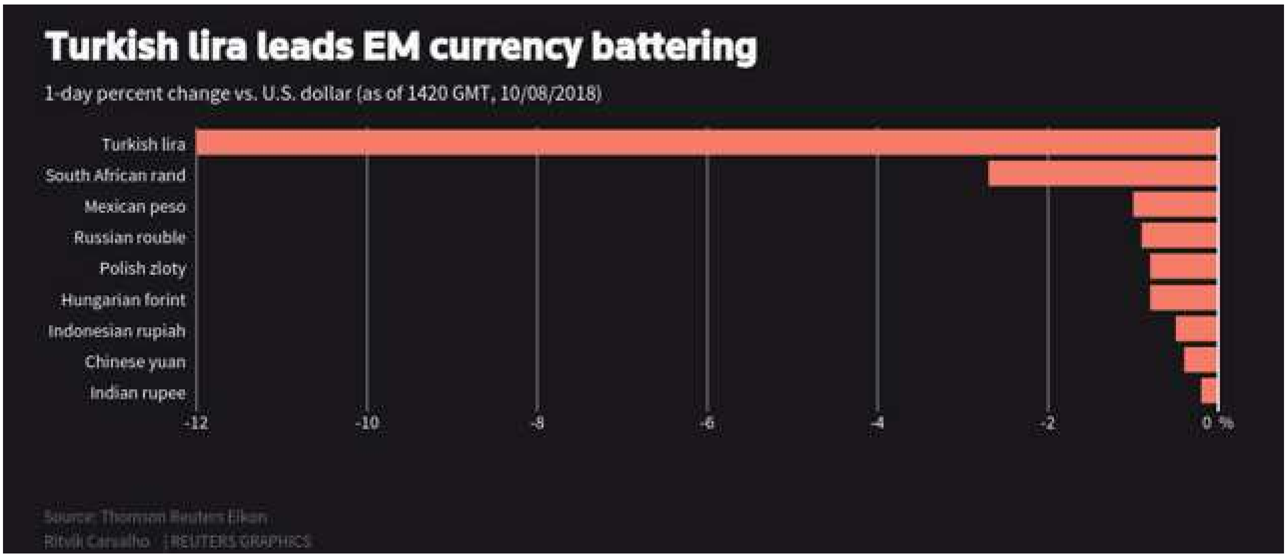
- **The yield on Turkish 10-year treasury debt is now over 25%**



- **The total market-cap of the Turkish equity market shrunk to $118.5B, lowest since 2009**. To put this into perspective, the entire Turkish market-cap is now worth just as much as 3M (MMM) - which is only ranked 72nd in the list of world's largest corporations.

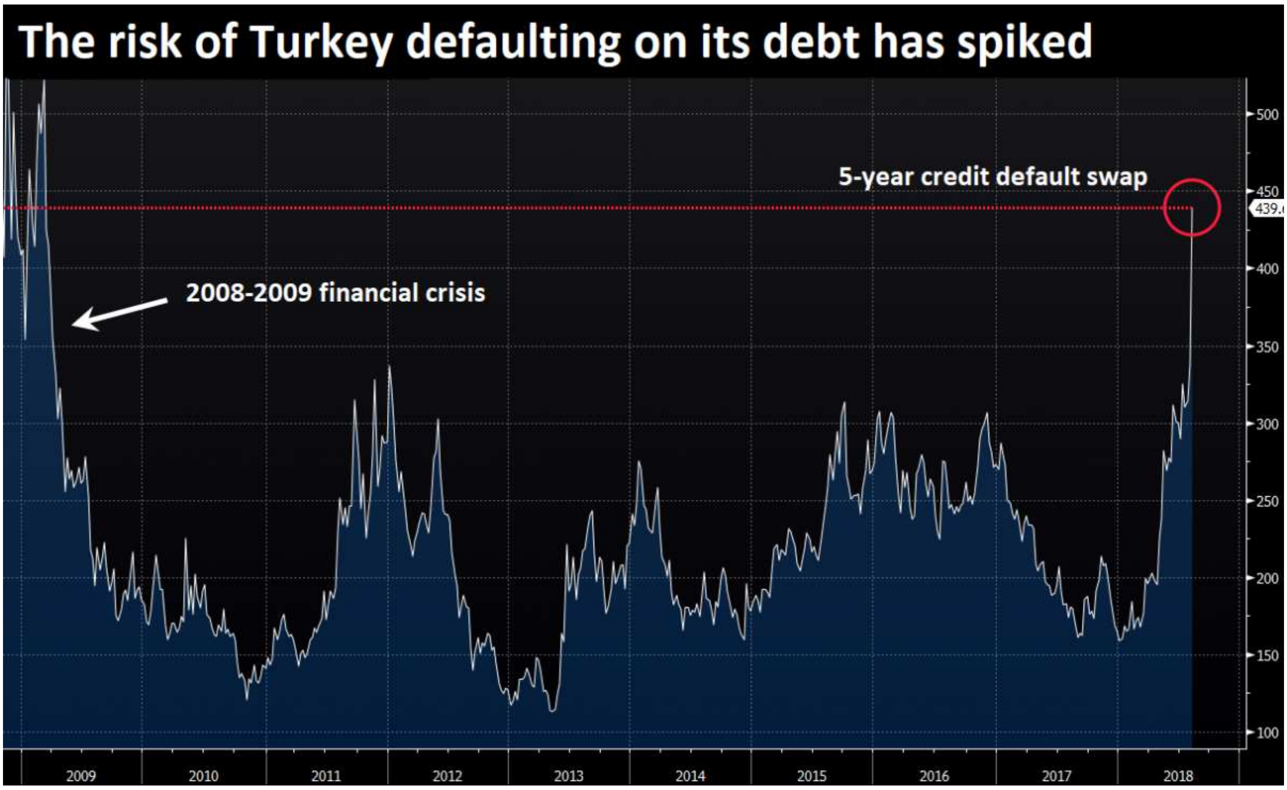
- **Largest exporters to Turkey, as percentage of each country's total exports, are Russia (RSX, RUSL) and Iran**. With such friends, who needs enemies?...



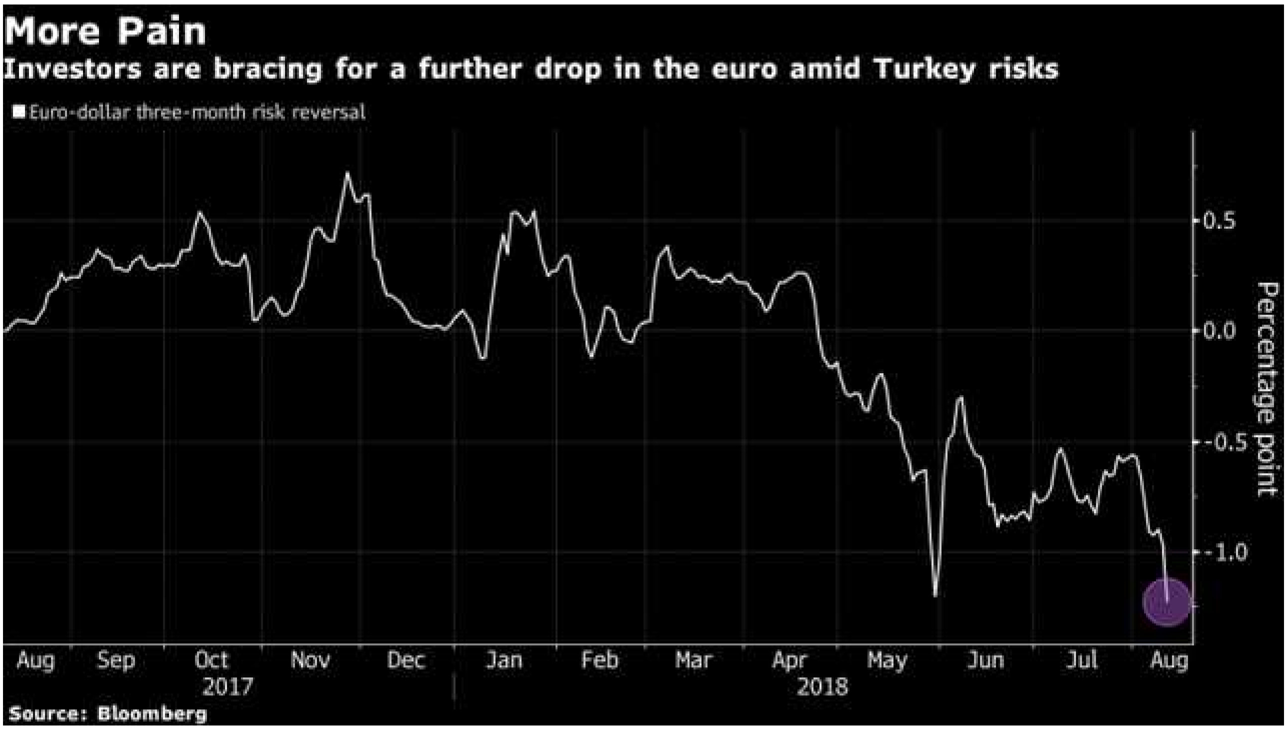


- In case this wasn't clear, **the Turkish Lira is at an all-time low**.

- **Cost of insuring Turkish government debt against default has soared to subprime crisis levels**.



- **This is not the end. More pain is expected to come.**



Turkey's TUR: Too Big to Fail?

It's important to remember that Turkey is the 17th largest world economy by GDP and the 13th largest economy by purchasing power parity ("PPP").

Is Turkey/TUR a "Too Big To Fail" country/trade? Possibly. If so, either the country recovers with external help. If not, Turkey can easily crater and pull down the rest of the world and its stock markets via the "*Butterfly Effect*."

It's no surprise then that the TUR has seen a record day last Friday:

- Down 14.5% for the day, second worst one-day decline (First-rank is October 15th 2008 with a -14.9% decline)
- Shares Traded: 13.2M; highest volume day in the ETF history.
- Shares Outstanding: 14.1M, i.e. almost the entire ETF capacity has changed hands on a single trading day.

Unfortunately for all investors, the dispute between Turkey and the US has a far-reaching global impact, with the European banking system being the most vulnerable one to the Turkish bloodshed bath.

Unsurprisingly, officials at the European Central Bank ("ECB") are now very concerned over southern European banks' substantial exposure to Turkey. Clearly, investors with long positions in European banks are at risk.

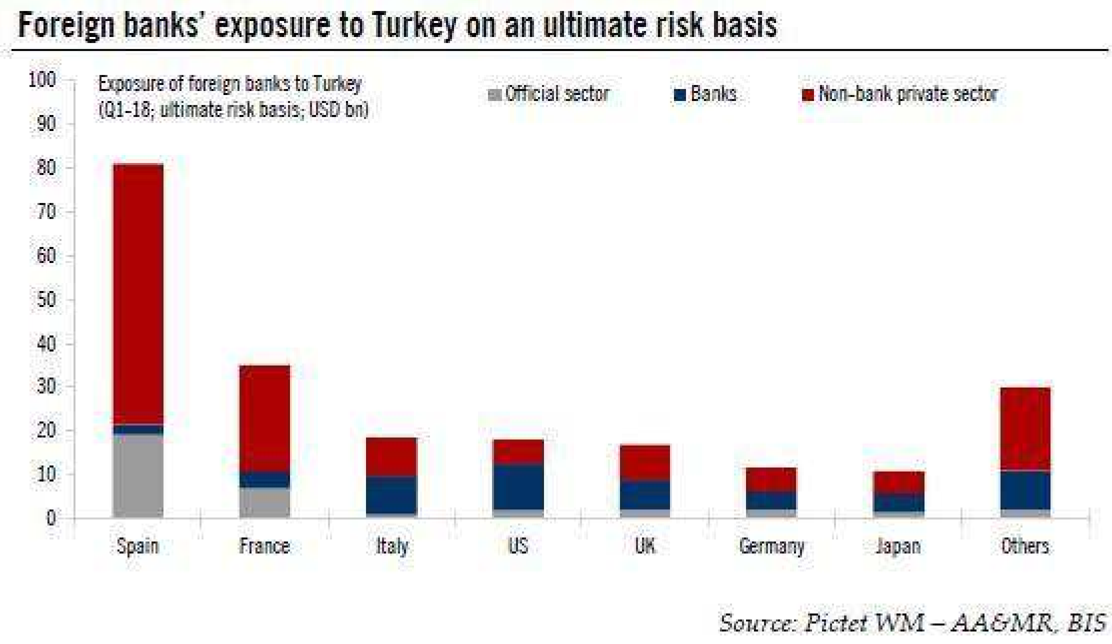
Data from the Bank for International Settlements ("BIS"), aka "the central bank of central banks", shows that Spanish banks are owed $83.3B by Turkish borrowers; French lenders $38.4B; and banks in Italy are owed $17B. Those aren't small amounts - especially when it comes to Spain - and European regulators are correct being worried that a weaker Lira will lead to defaults of Turkish borrowers on their foreign, mainly EUR-denominated, loans.

Defaults on debts in this scale could potentially threaten the stability of the entire European financial system - not for first time/cause:

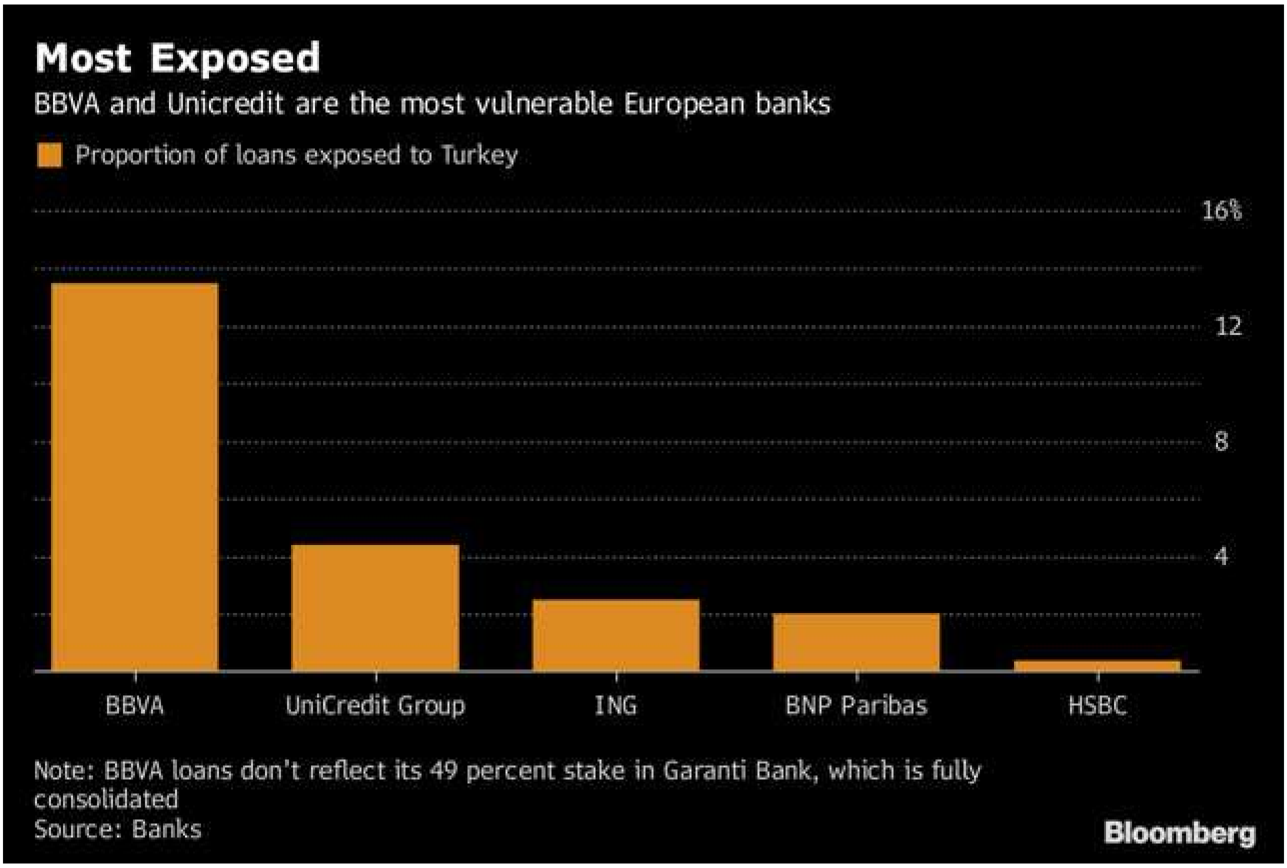
- Deutsche Bank, Banks And The USD: The Writing (OFF) Is On The Wall (Street)
- The Italian Job - Part I: USD Vs. EUR

- The Italian Job - Part II: American Vs. European Banks
- The Italian Job - Part III: Deutsche Bank Vs. JPMorgan
- The Italian Job - Part IV: Diversification And Emerging Markets

Other banks around the world, outside of the European financial system, are not immune and some are also heavily exposed to Turkish debt. British banks hold $19.2B of debt, Japanese banks hold $14B, and even US banks hold $18B. Nevertheless, unlike Spain, for these countries/economies those are negligible-manageable amounts.



Out of the most Turkey-indebted countries, here are the European banks that carry the highest Turkish exposure:



Representing Spain: BBVA (BBVA)

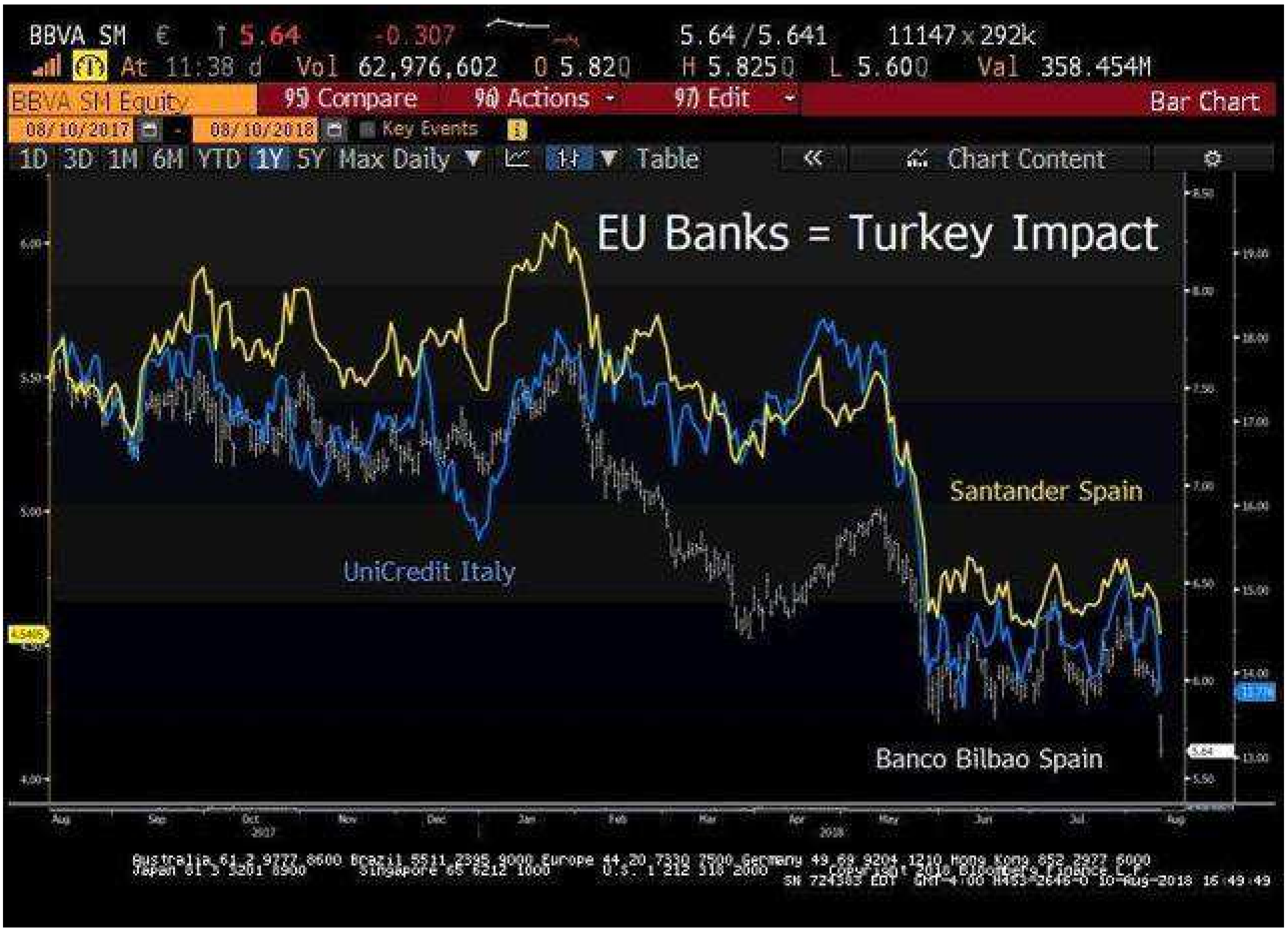
Representing Italy: UniCredit (OTCPK:UNCFF, OTCPK:UNCRY)

Representing the Netherlands (EWN) (Netherlands!?...): ING Groep (ING)

Representing France: BNP Paribas (OTCQX:BNPQF, OTCQX:BNPQY, OTCPK:BNPZY)

Representing the UK: HSBC Holdings (HSBC)

Not in the chart but worth paying attention to: Deutsche Bank (DB), Germany's largest bank, Banco Santander (SAN), Spain's largest bank, and Barclays (BCS) which also has a noticeable (though relatively small) exposure.



Here's how the most-exposed banks' shares performed last Friday:

Name	Last	% Change
ING GROEP/d	12.0700	-4.74 %
BNP PARIBAS/d	51.9700	-4.08 %
UNICREDIT/d	13.6760	-5.42 %
BBVA/d	5.6350	-5.2463 %

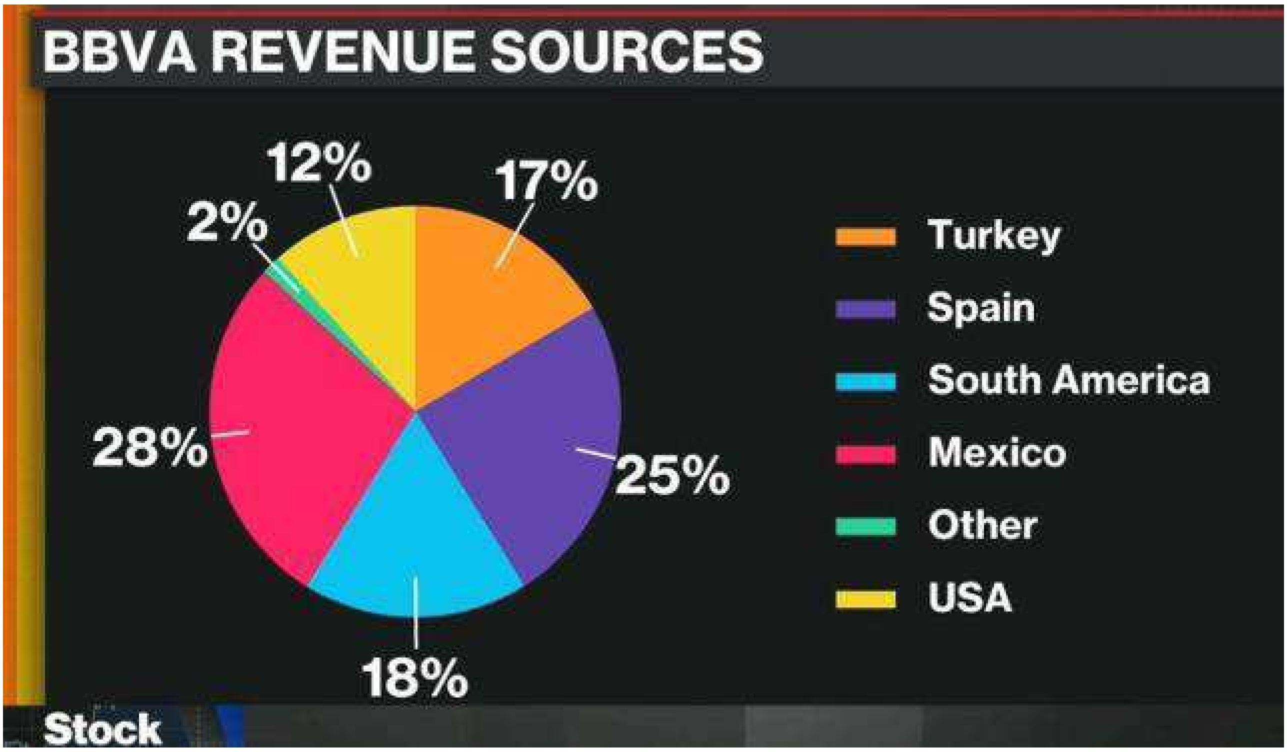
More or less as one would expect.

Let's now focus on the two most exposed banks: BBVA and UniCredit.

Spain's BBVA

Once upon a time, Spain's second biggest bank, Banco Bilbao Vizcaya Argentaria (BBVA), was a distinguished member of the global club of systemically important financial institutions ("SIFI"). It was, officially speaking, one of those "too big to fail" financial entities. That all changed about three years ago (November 2015), when it was decided that BBVA had "declining systemic importance." Not sure whether this is more of a reputation loss or a real-financial loss. Either way, the bank lost its SIFI status and was relegated to mere mortal status, now presumably allowed to fail.

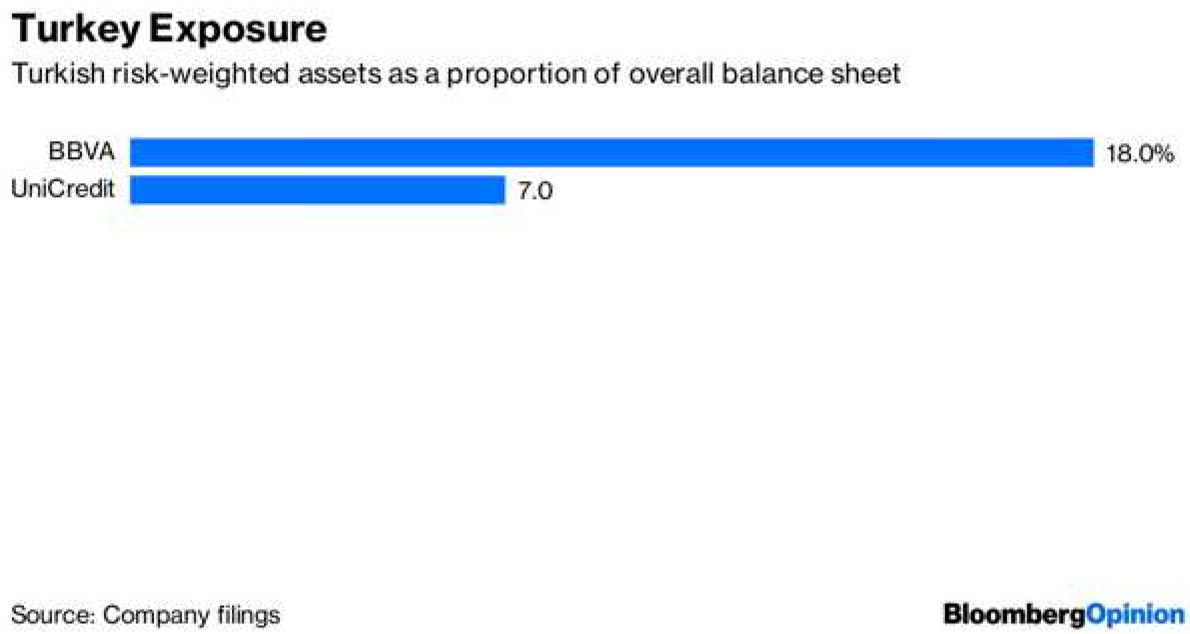
Fact is that BBVA makes most of its money outside Spain. Its two main overseas profit centers are Mexico, where the bank owns a majority stake in the second biggest bank, Bancomer, and Turkey, where it recently consolidated its control of Garanti, the country's third biggest bank. The acquisition of 40% of the bank's shares gave BBVA control of the board and a huge presence in what was seen (back in the days) as a very important - and lucrative - emerging market.



In the good times, BBVA's investment in Turkey paid off handsomely. However now, times have changed for an already deeply divided nation (as evident by the recent elections). BBVA is, by far, the most vulnerable among all European banks to risks linked to any political turmoil in Turkey and/or economical dispute with its foreign allies. The next four most-at-risk banks: Italy's embattled TBTF entity Unicredit, French behemoth BNP Paribas, Dutch giant ING, and the UK's ultimate refuge of scoundrels, HSBC.

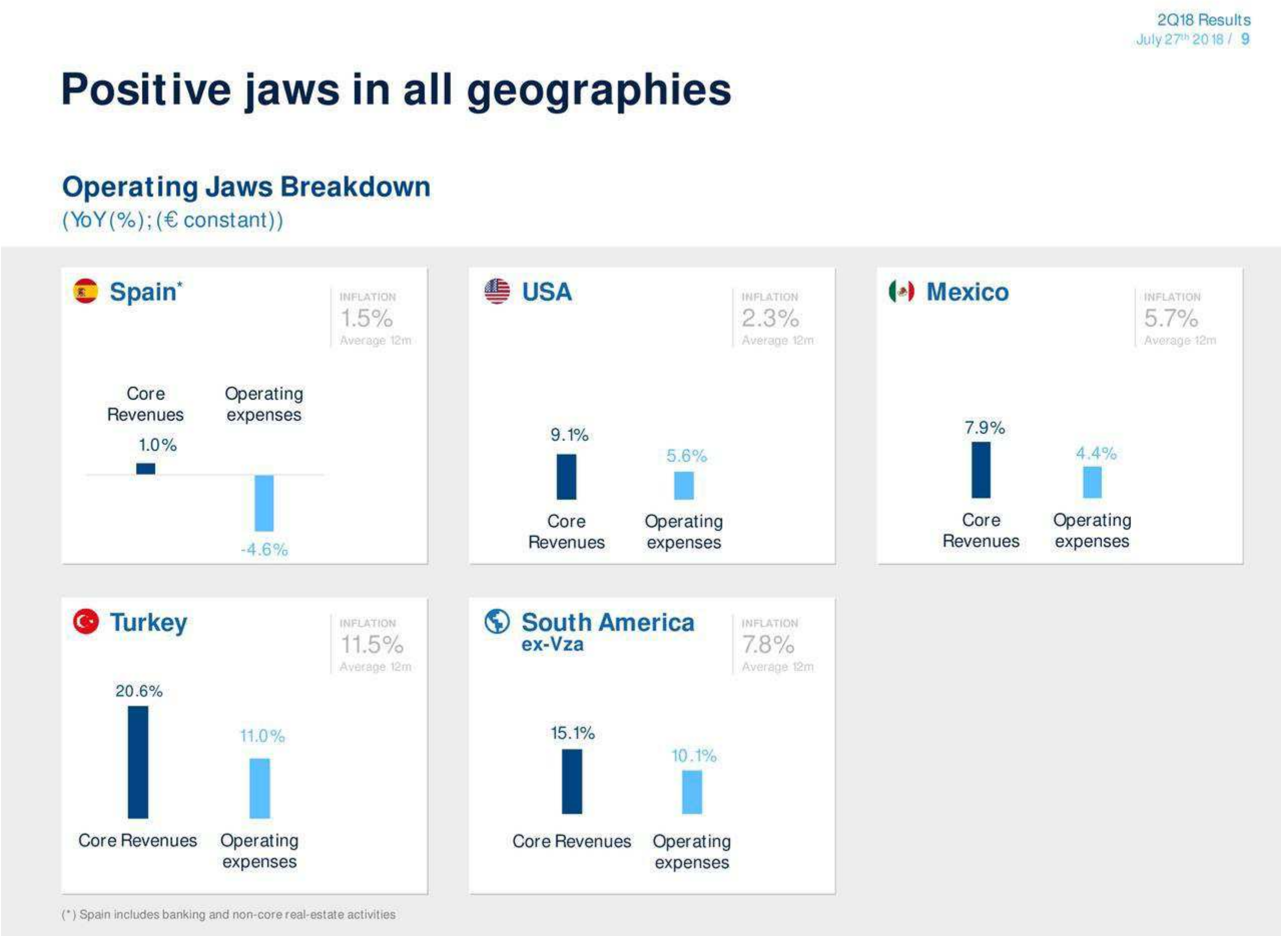
Other than BBVA's Profit Exposure the main Balance Sheet exposure they have is their 49.5% share holding in Garanti Bankasi (Turkey's 3rd largest lending bank).

With its fair chunk of exposure to Turkey than the others, BBVA share was down 6% (hot on the tail of UniCredit, which had trading halted earlier)



Jefferies analysts said Turkey contributed 14% to BBVA's first-half group profit and 9% to UniCredit's consolidated profit, although their capital exposure is limited. Both banks have said a 10% fall in the lira could shave two basis points off their capital adequacy ratio.

Remember the song "*Things that make me go hmmm*...."? Well, here are BBVA-related things that make me go hmmm....



Source: BBVA's presentation for Q2/2018

BBVA has been falling since the end of January after spending most of 2017 setting a top. most of it due to a Eurozone financial sector wide outlook, i.e. tight correlation, but recent under-performance can be hailed to exposure to Turkey

Italy's UniCredit

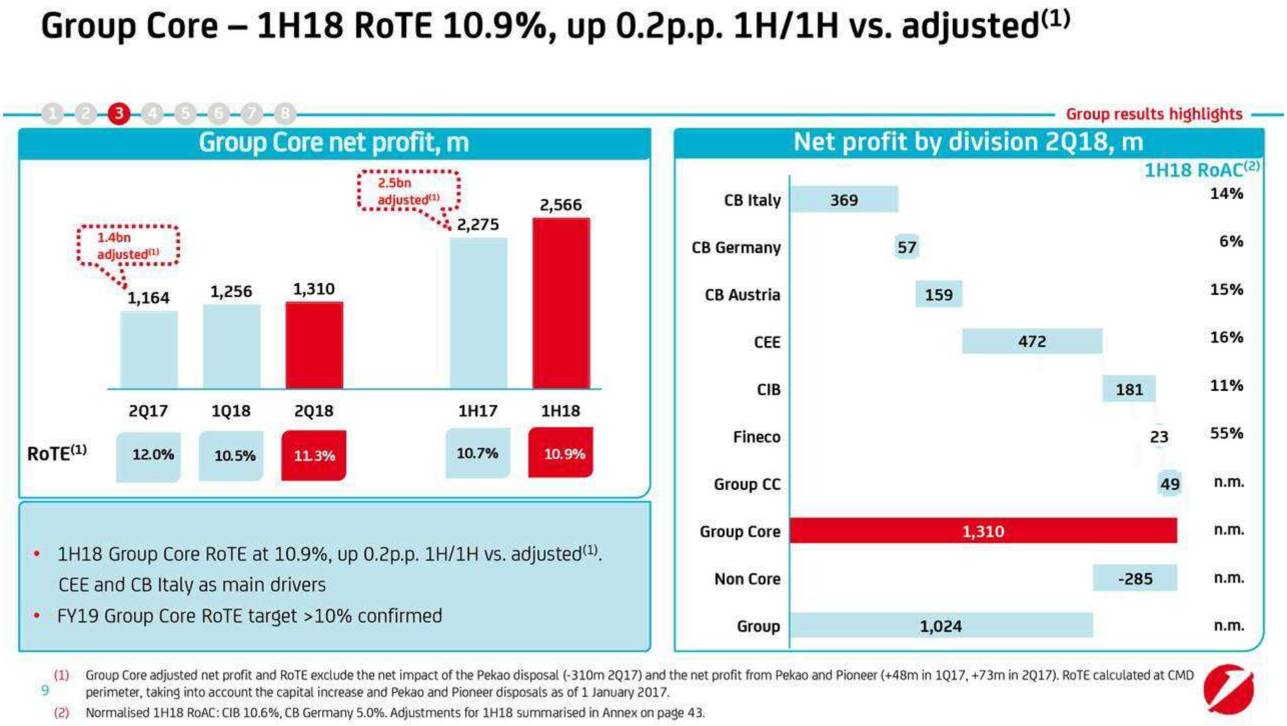
In its first-half financial report, UniCredit has warned about Turkey, stating that "the credit-led growth model seems to be running out of steam, while a sharp rise in funding costs forced private and foreign banks to slow lending."

The report also reveals that the bank's risk-management group is especially focused on Russia, Brexit and challenges from regulation.

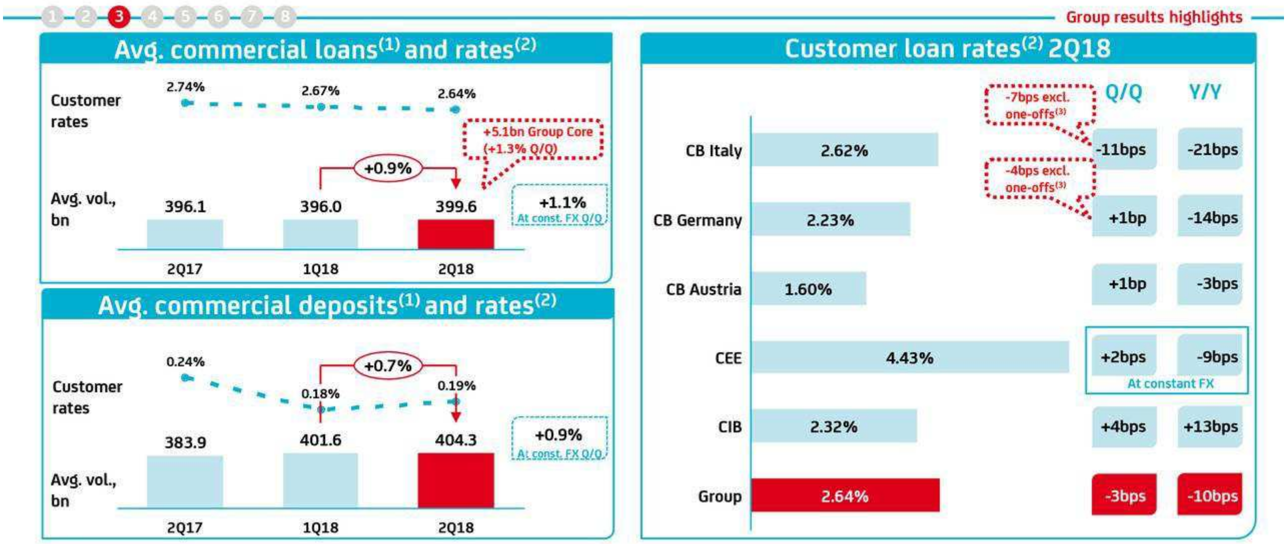
The Italian-led banking empire sprawls over 14 countries, and serving about 25M clients. UniCredit jointly controls Turkey's Yapi Kredi Bankasi AS, the fourth largest publicly owned bank in Turkey by its asset size. It was only four months ago when the Italian bank injected about $1B worth (at the time) into Yapi Kredi, as part of a rights issue. With the Turkish Lira plummeting against the US Dollar and the tension between the US and Turkey rising this investment seemed now like a quick waste of big money.

Just like BBVA, UniCredit is under pressure not only as a result of profit exposure but also due its direct equity investment in Turkish banks. A relatively high level of participation in syndicated loans - a loan offered by a group of lenders - is also part of the exposure.

ere are UniCredit-related things that make me go hmmm.... (Note that Turkey is part of UniCredit's CIB region)

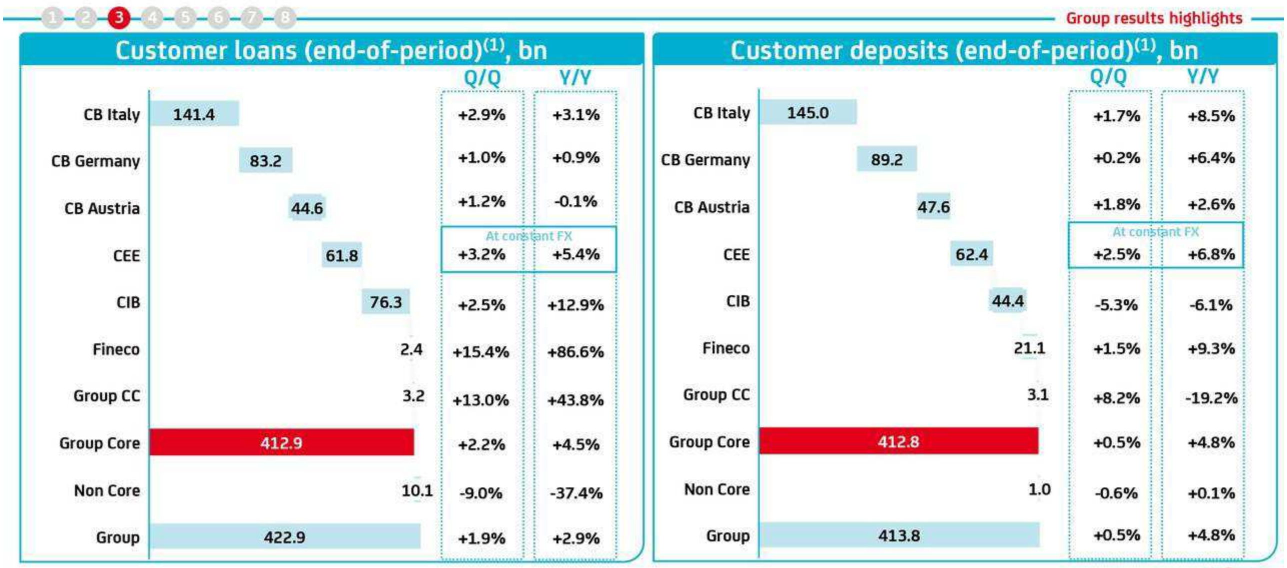


Group – Average Group Core loan volumes up 5.1bn Q/Q



(1) Average commercial volumes are managerial figures and are calculated as daily averages. Loans net of provisions.
(2) Customer loan rates calculated assuming the 365 days convention.
13 (3) Excluding one-offs in CB Italy (days effect, factoring) and CB Germany (extraordinary recovery).

Group – End-of-period Group Core customer loans up 9.0bn Q/Q



14 (1) End-of-period accounting volumes calculated excluding repos and intercompany items.

CIB – Net operating profit 0.7bn, up 11.1% Y/Y thanks to non-recurring write-backs

1 2 3 4 5 6 7 8 — Divisional results highlights

Main drivers

- Challenging market environment led to lower client activity and thus lower fees and trading. Client driven revenues at 78% in 2Q18
- Net interest up 0.3% Q/Q due to slightly higher customer rates and increased loan volumes
- Fees down 17.1% Y/Y mainly due to weaker Capital Markets business in 2Q18 vs very strong 2Q17. Market shares stable
- Leading franchise confirmed: #1 in "All Bonds in EUR"[1] in Italy and Germany, #2 in "EMEA All Bonds in EUR"[1] by number of transactions
- Trading income down 53.3% Y/Y due to spread widening negatively impacting market making, lower institutional flows and less FVOCI gains
- Confirmed cost discipline, costs down 7.4% Y/Y. 1H18 C/I ratio at 39.8%, one of the lowest in the industry
- CoR at -77bps in 2Q18 driven by non-recurring write-backs
- Normalised[2] RoAC at 10.6% in 1H18

Data in m	*2Q17*	*1Q18*	*2Q18*	*Δ % vs.1Q18*	*Δ % vs.2Q17*	*1H17*	*1H18*	*Δ % vs. 1H17*
Total revenues	1,034	1,099	858	-21.9%	-17.0%	2,196	1,957	-10.9%
o/w Net interest	*553*	*556*	*558*	*+0.3%*	*+0.9%*	*1,087*	*1,114*	*+2.5%*
o/w Fees	*180*	*162*	*149*	*-7.8%*	*-17.1%*	*326*	*311*	*-4.6%*
o/w Trading	*281*	*328*	*131*	*-60.0%*	*-53.3%*	*738*	*459*	*-37.7%*
Operating costs	-411	-399	-381	-4.4%	-7.4%	-841	-780	-7.3%
Gross operating profit	623	700	477	-31.9%	-23.4%	1,355	1,178	-13.1%
LLP	-5	-49	210	n.m.	n.m.	-85	161	n.m.
Net operating profit	618	652	687	+5.5%	+11.1%	1,270	1,339	+5.5%
Net profit	402	378	181	-52.1%	-54.9%	753	559	-25.8%
RoAC	17.5%	15.7%	7.3%	-8.4p.p.	-10.1p.p.	16.1%	11.4%	-4.6p.p.
C/I	39.8%	36.3%	44.4%	+8.1p.p.	+4.6p.p.	38.3%	39.8%	+1.5p.p.
CoR (bps)	2	19	-77	-96bps	-78bps	17	-30	-47bps
FTEs	3,440	3,260	3,331	+2.2%	-3.2%	3,440	3,331	-3.2%
Gross NPE ratio	3.7%	2.9%	2.4%	-47bps	-128bps	3.7%	2.4%	-128bps

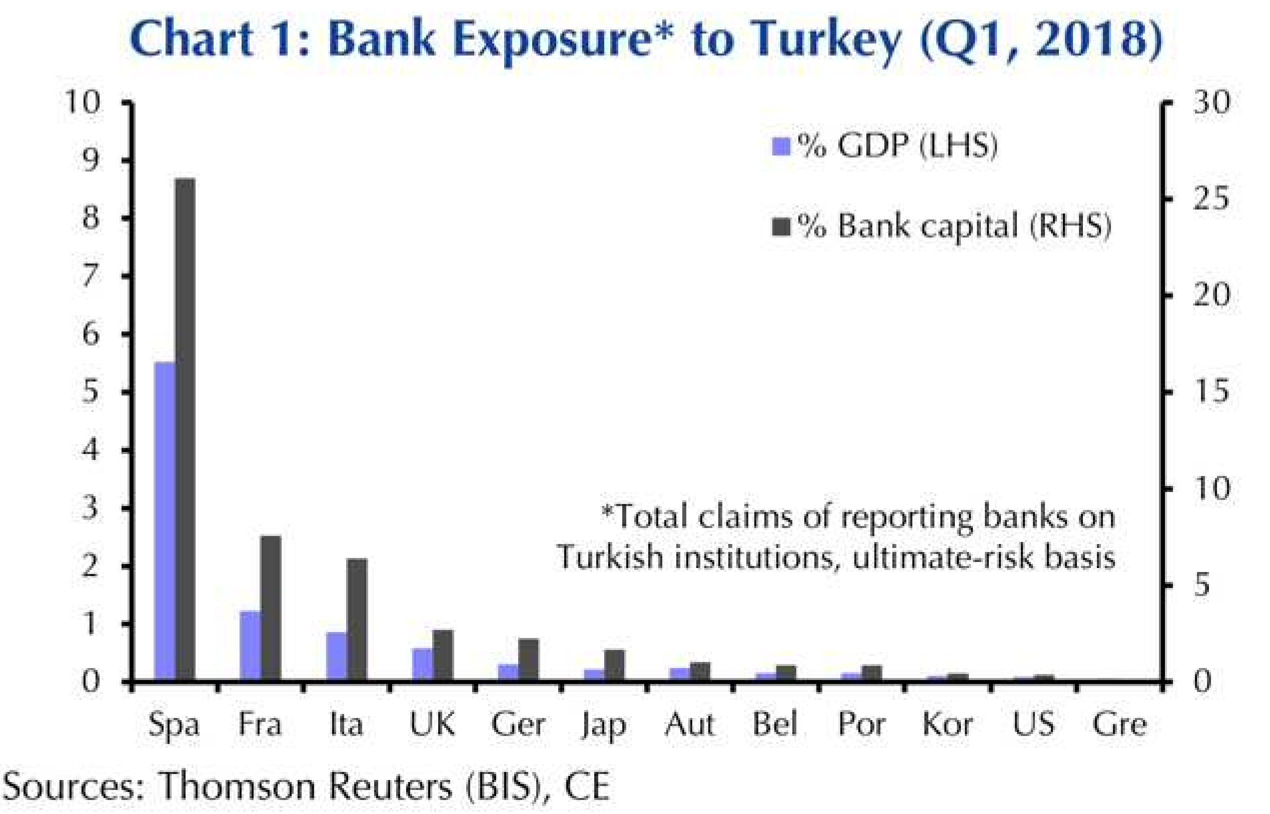
26 (1) Source: Dealogic, as of 4 July 2018. Period 1 January – 30 June 2018; rankings by volume, unless otherwise stated.
(2) Normalised RoAC for non-recurring net trading gains from participations +39m in 1Q18. 2Q18 net profit negatively affected by non-recurring other charges & provisions.

Source: Credit's presentation for Q2/2018

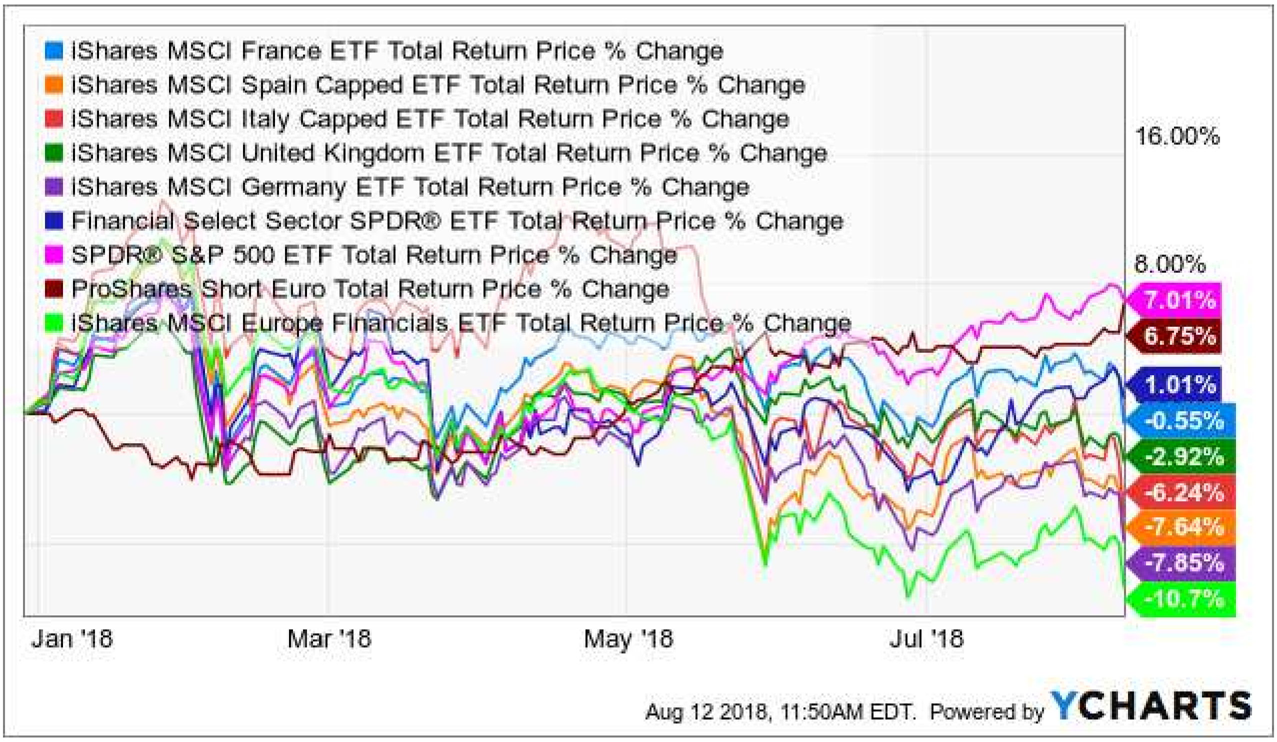
Only Forty Days Later

Let's look at few charts now, only forty days later.

First of all, a closer look at the most exposed countries. As a reminder, this is how the exposures look like:



Now, let's see how these countries' ETFs have performed YTD:

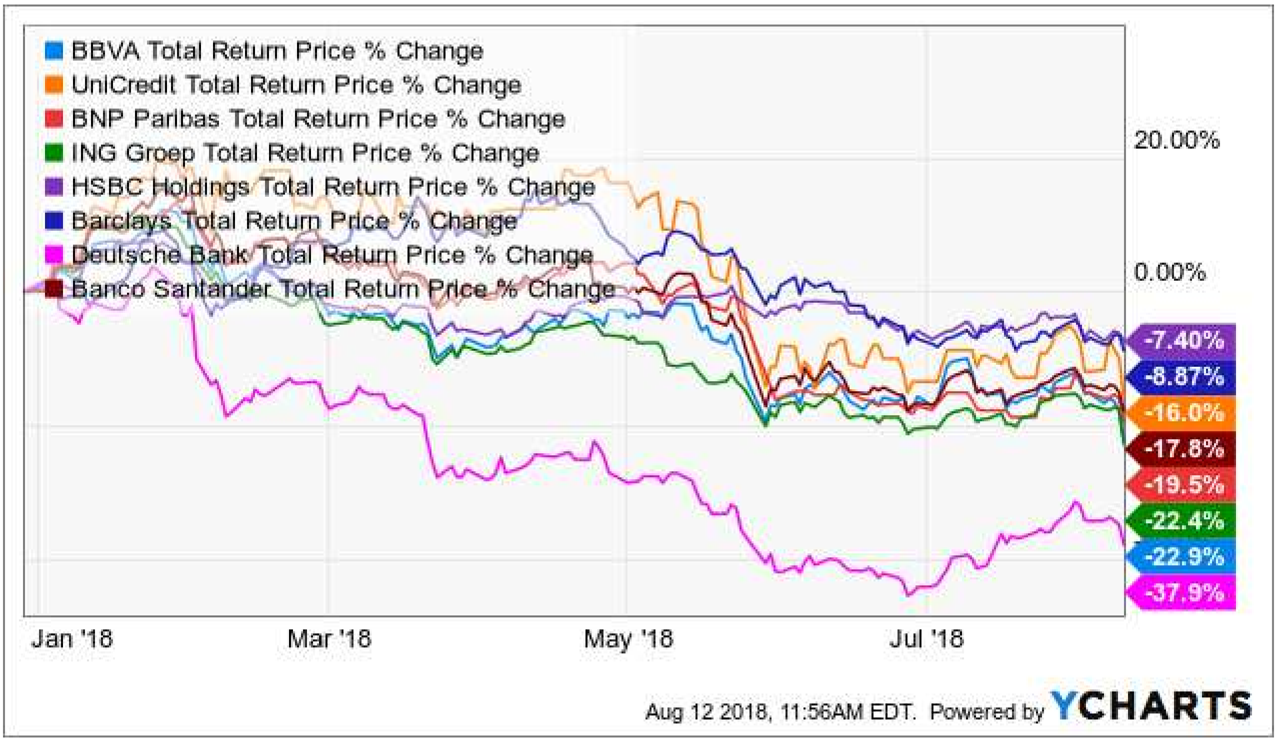


EWQ Total Return Price data by YCharts

In short:

- Sorting the Euro, using ProShares Short Euro (EUFX) = A good idea
- US banks, Financial Select Sector SPDR® ETF (XLF), performing much better than European banks, iShares MSCI Europe Financials ETF (EUFN)
- The US market, SPDR® S&P 500 ETF (SPY), has outperformed each and every relevant-main European market/index: iShares MSCI France ETF (EWQ), iShares MSCI Spain Capped ETF (EWP), iShares MSCI Italy Capped ETF (EWI), iShares MSCI United Kingdom ETF (EWU) and iShares MSCI Germany ETF (EWG). As a matter of fact, all European markets are in the red YTD, even on a total return basis!

Now let's take a closer look at the banks with the highest exposure to Turkey:



BBVA Total Return Price data by YCharts

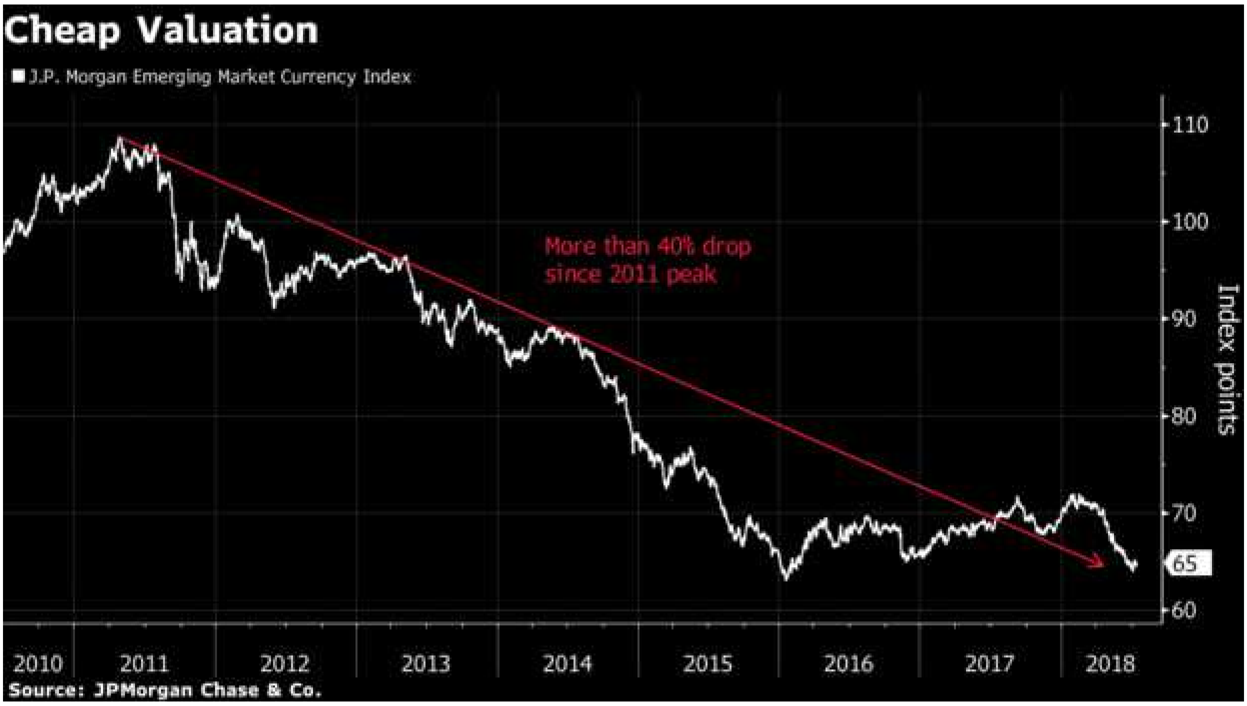
Deutsche Bank (DB) is leading the way but not due to its Turkish exposure rather due to other, even more severe, issues. For more details about those please take a closer look at our recent coverage of the German leading bank:

- New Records Time: Longest Losing Streak For Banks And An All-Time Low For Deutsche Bank
- The Italian Job - Part III: Deutsche Bank Vs. JPMorgan
- Deutsche Bank, Banks And The USD: The Writing (OFF) Is On The Wall (Street)

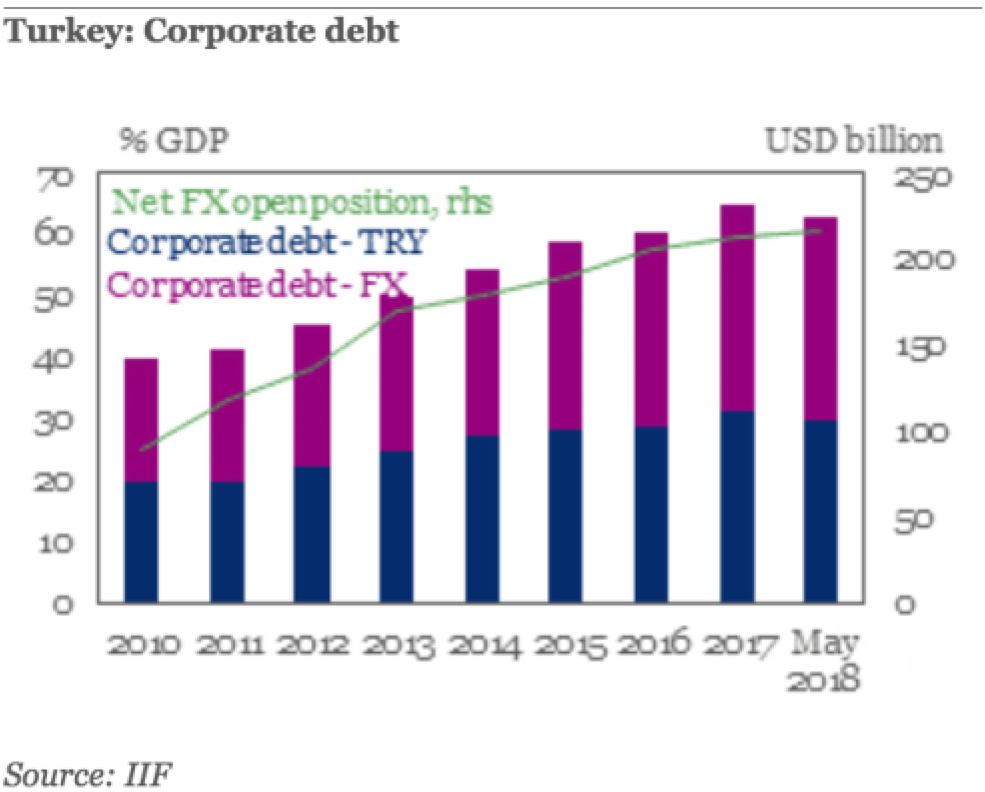
BBVA is down ~23% YTD, leading the rest of the pack (excluding DB), as one would expect. ING Groep is only half a percent better than that; really nothing to cheer about. BNP Paribas comes at third place, followed by Banco Santander, UniCredit, Barclays and HSBC Holdings.

Bottom Line

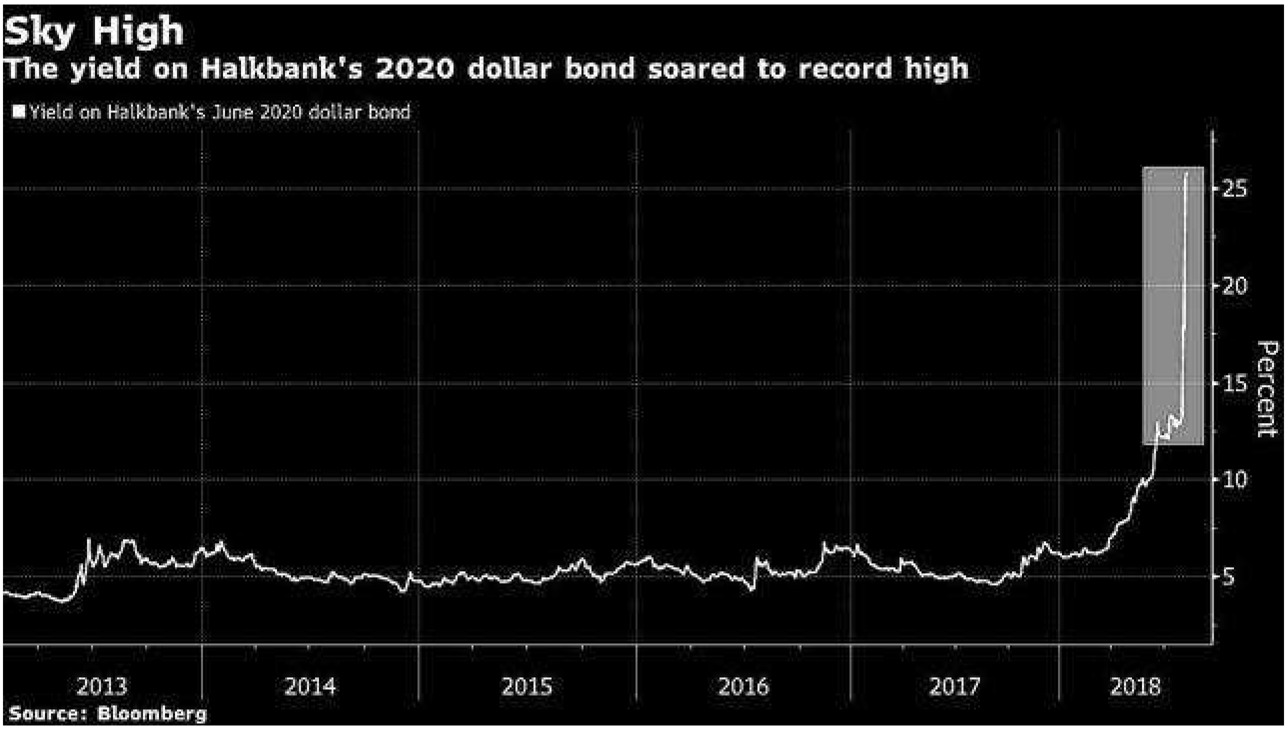
It's clear that the exposures to emerging markets are now being a heavy and costly drag on these giant banking groups' shoulders. With so many leading countries/economies facing major risks, all at once, these banking groups are almost doom to fail unless a recovery (which is currently not at sight) is coming soon.



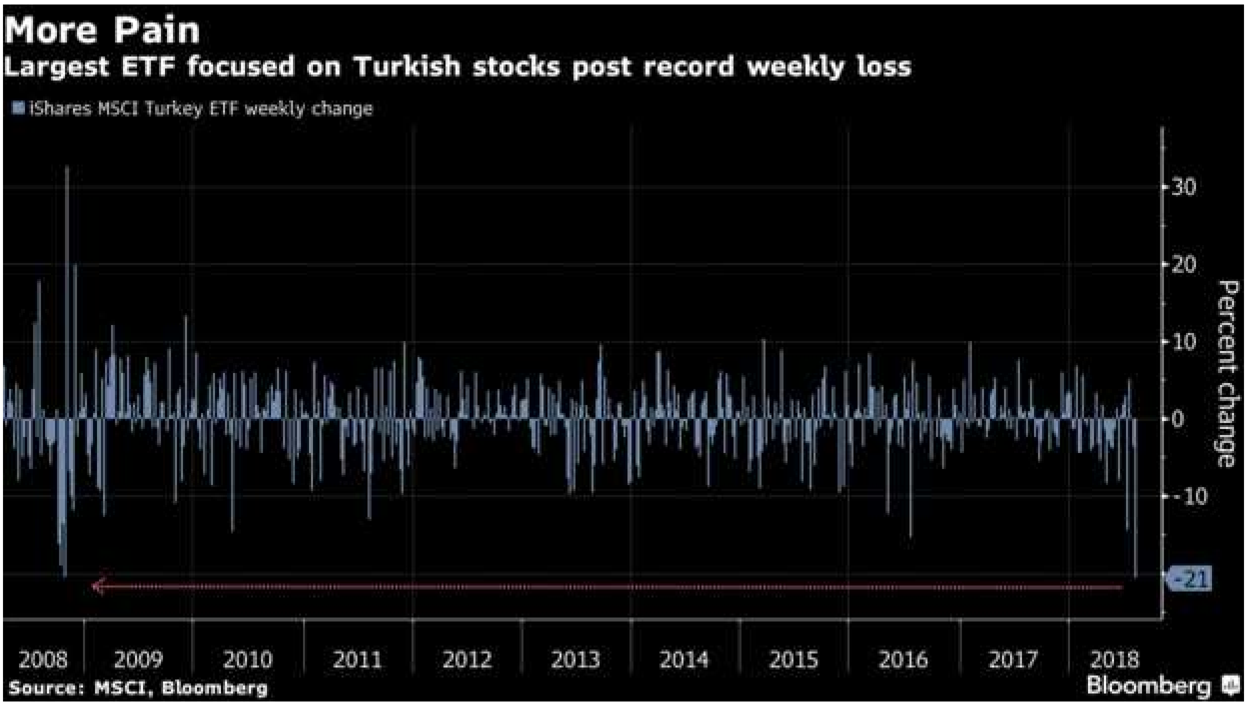
Argentina (ARGT), Brazil (EWZ, BRF), Russia, China (FXI) and now Turkey - we only need India (EPI, INDA) and South Africa (EZA) to join the "party" in order to have a full BRIC-SAT house. That's a party you don't wish to participate in, if you're a world's major banking group.



It's already very painful out there in Turkey:



And more pain is likely upon us to come:



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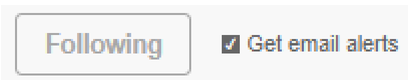

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Disclosure: I am/we are long JPM.

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