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Credit flap, sterling gap, Spanish map

Economics: Divergent lending & debt dynamics (pages 2-5)

- Southern European consumer credit surges but other lending subdued
- Ireland back in the old routine, with rising house prices and borrowing

Markets: GBP – mind the gap? (pages 6-7)

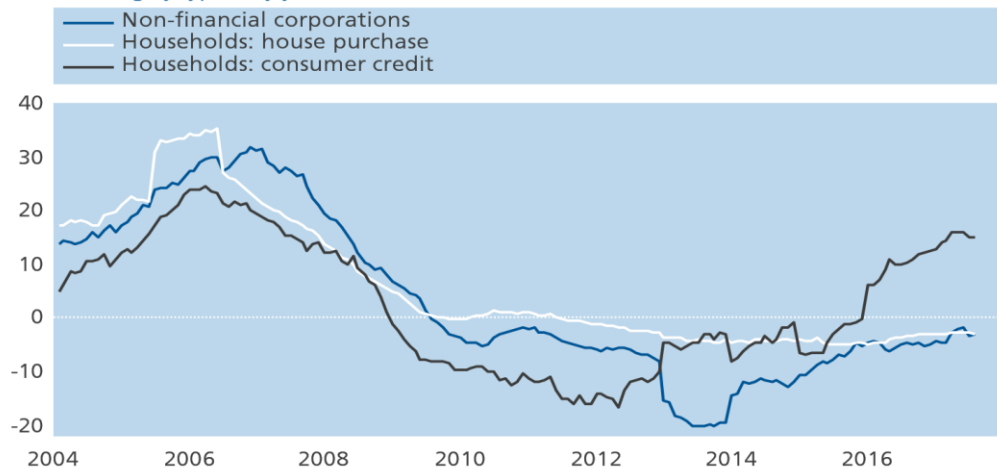
- Hawkish Bank of England tone takes markets by surprise
- Short squeeze driving sterling strength, will be a fade later

Politics: A Catalan stand-off (pages 8-9)

- Catalonia's planned independence vote will not lead to secession
- A protracted row could follow – and perhaps eventual fiscal autonomy

Surge in Spanish consumer credit - reasons to be cheerful or fearful?

Bank lending by type (% y/y)



Source: Thomson Reuters Datastream, TS Lombard, ECB

Important information
Please see disclaimer ⓘ

Economics: Divergent lending & debt dynamics

- Consumer credit growth has surged in southern Europe. Mortgage lending dynamics are much less vigorous, however.
- Germany and Italy have relatively low household debt in common but their lending and house price dynamics have diverged.
- Ireland is back in the old routine, with rates of increase in house prices and mortgage lending accelerating again.

Spain: surge in consumer credit...

Double-digit consumer credit growth in Spain

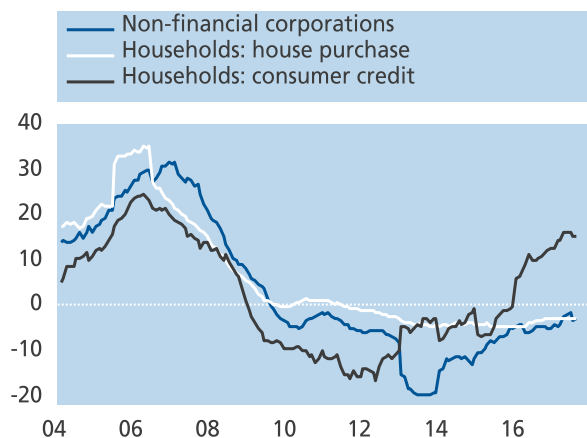
The various sub-categories of bank lending data across the euro area show some interesting dynamics and divergences. One of the most striking is the surge in consumer credit growth in Spain (Charts 1 & 5). The y/y rate of increase was over 15% in July and has been in double digits since spring 2016. Is there trouble brewing?

...but bigger picture less alarming

But consumer credit a small fraction of total lending...

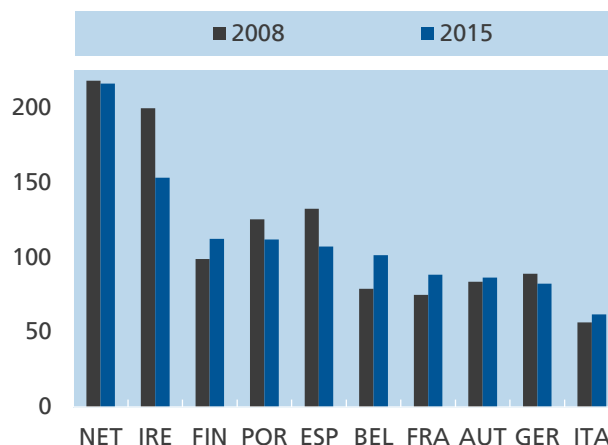
Despite its recent vigour, consumer credit still accounts for a relatively small proportion of the overall stock of loans to the Spanish private sector. From a low of around 3½% in 2012, the ratio has risen to just under 6% at present, broadly in line with the euro area average and roughly half of the equivalent ratio in the UK.

Chart 1: Spanish bank lending by type (% y/y)



Source: Thomson Reuters Datastream, TS Lombard, ECB

Chart 2: Gross household debt to income (%)



Source: Thomson Reuters Datastream, TS Lombard, Eurostat

...while lending growth for mortgages and to NFCs is still declining

A key difference between the current situation in Spain and the pre-crisis period is that similarly strong upward dynamics are not evident in either lending for mortgages or to non-financial corporates (NFCs) which account for the bulk of private sector lending. In y/y terms, both forms of lending are contracting still, albeit at a reduced pace. While Spain's gross household debt to income ratio is still relatively elevated, there has been a considerable reduction post-crisis (Chart 2).

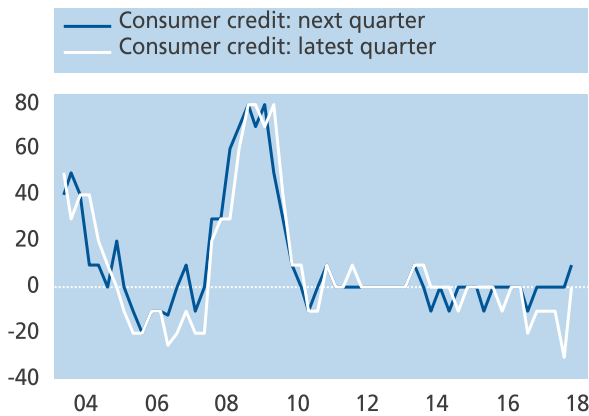
Credit standards are tightening

The ECB's quarterly Bank Lending Survey (BLS) had shown a pronounced easing of credit standards for consumer credit in Spain, much more so than for mortgage lending (Chart 3). But a tightening is now in train and the forward-looking elements of the latest BLS (compiled in June) suggest that this has further to go.

On the demand side of the BLS, the indications have been rather mixed (Chart 4). Reported demand for consumer credit in Spain had been much higher than for the euro area as a whole from 2014. This started to ease off last year, only to perk up again recently.

Chart 3: Spanish credit standards

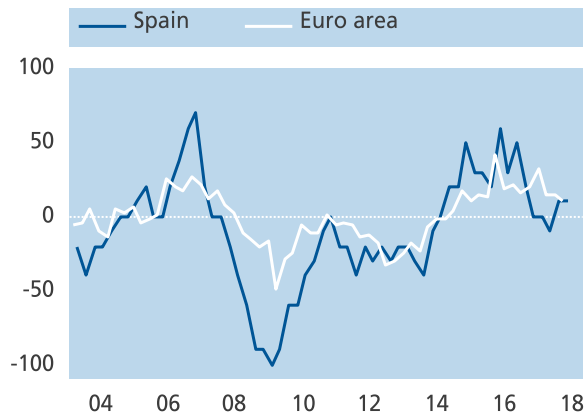
ECB bank lending survey, net balances



Source: Thomson Reuters Datastream, TS Lombard, ECB

Chart 4: Demand for consumer credit

ECB bank lending survey, net balances, latest quarter



Source: Thomson Reuters Datastream, TS Lombard, ECB

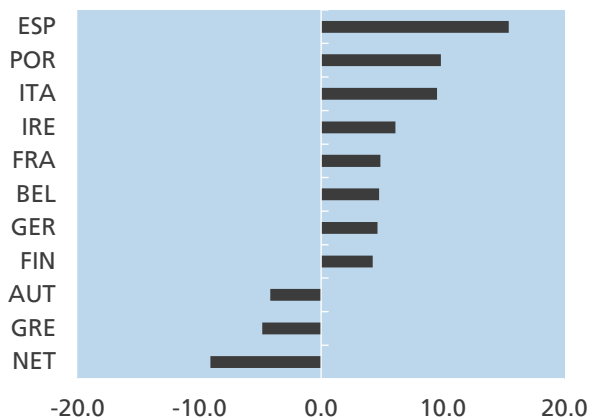
Periphery: compare and contrast

Consumer credit growth strong in Italy and Portugal too

Consumer credit is also expanding relatively briskly elsewhere in southern Europe. Though less elevated than in Spain, y/y growth rates in both Italy and Portugal are running close to double digits (Chart 5). Consumer credit also accounts for relatively small shares of overall private sector lending in both Italy and Portugal.

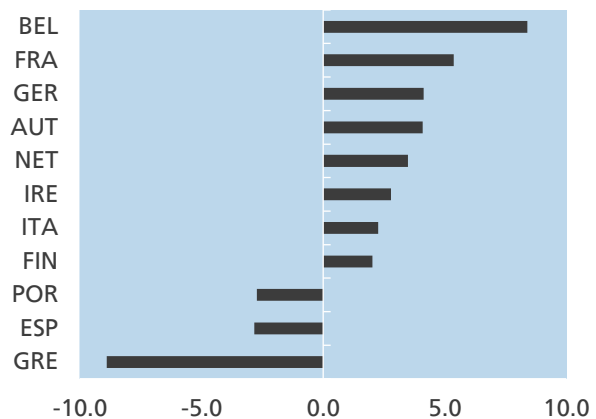
Mortgage lending dynamics have been more divergent, with Italy's y/y growth rate now back in positive territory (Chart 6).

Chart 5: Consumer credit (% y/y, 3mmav)



Source: Thomson Reuters Datastream, TS Lombard, ECB

Chart 6: Mortgage lending (% y/y, 3mmav)



Source: Thomson Reuters Datastream, TS Lombard, ECB

Italy: low household debt...

Low household debt burden in Italy

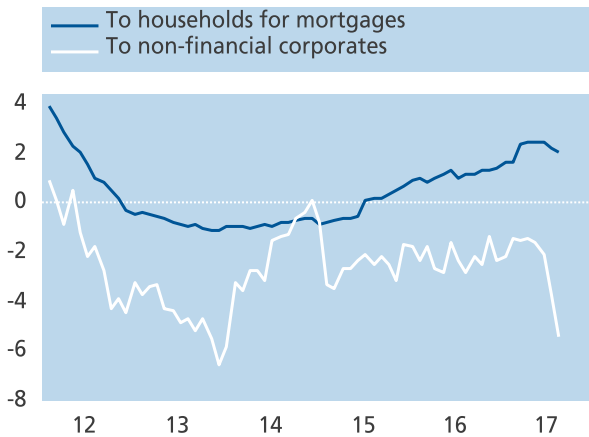
A significant difference between Italy and the other 'peripheral' euro area economies is its relatively low household debt. Italy's gross household debt to income ratio is the lowest among the ten largest euro area economies by quite some distance (Chart 2).

Mortgage lending also accounts for a relatively small share of the stock of private sector loans relative to lending to NFCs which is more than twice as large. In most of the rest of the euro area there is typically a more even split between the two main categories of loans.

Italian mortgage lending expanding again

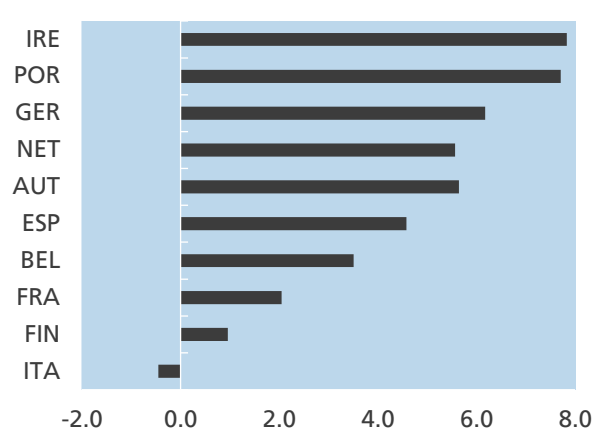
The y/y rate of change in Italian mortgage lending turned positive in mid-2015 and has been on a gradual upward trend since (Chart 7). In contrast, there has been a continued contraction in bank lending to Italian NFCs, which has deepened recently.

Chart 7: Italian bank lending by type (% y/y)



Source: Thomson Reuters Datastream, TS Lombard, ECB

Chart 8: House prices (% y/y, 3mmav)



Source: Thomson Reuters Datastream, TS Lombard, ECB

...and lagging house prices

Italian house prices still falling, for now

Another difference between Italy and the other large euro area countries is house price dynamics. According to Eurostat's harmonised residential house price data, y/y inflation rates are positive across the board with the notable exception of Italy (Chart 8).

Still, the rate of contraction in Italian house prices has been slowing, having bottomed out at around -6% y/y back in 2013. The rate of contraction is only marginal at present and with lending picking up and economic conditions improving, positive inflation rates will follow.

Ireland: back in the old routine...

Irish house prices rising again, along with mortgage lending

Eurostat's data also highlight relatively high house price inflation in Ireland (Chart 8). Having cooled off from the double-digit rates of increase evident in 2014/15, house price inflation is accelerating again and outstripping the other big-ten euro area countries. Mortgage lending in Ireland is also expanding again and has picked up pretty sharply in recent months, rising by over 6% y/y in July (unlike in Spain and Portugal whose household debt ratios are much lower).

The recent spurt in lending in Ireland follows a long contraction, however. Looking at mortgage lending in level terms rather than rates of change helps to illustrate the point (Chart 9).

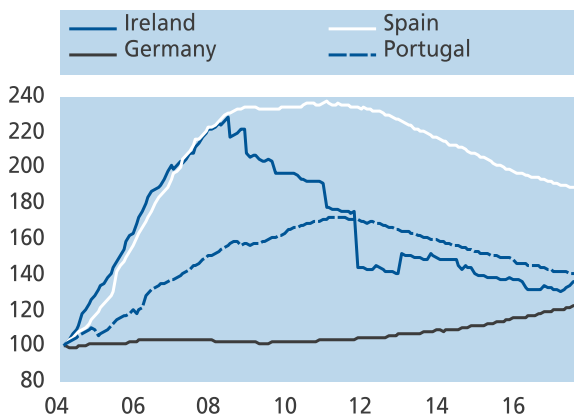
...with household debt still high post-deleveraging

Substantial post-crisis adjustment in Ireland but household debt remains relatively high

In both Ireland and Spain, there was a huge surge pre-crisis, with mortgage lending more than doubling between 2004 and 2008. Subsequently, there has been a far bigger adjustment in Ireland. Nonetheless, while deleveraging in Ireland has been substantial in the period since the crisis, its gross household debt to income ratio remains exceptionally high (Chart 2).

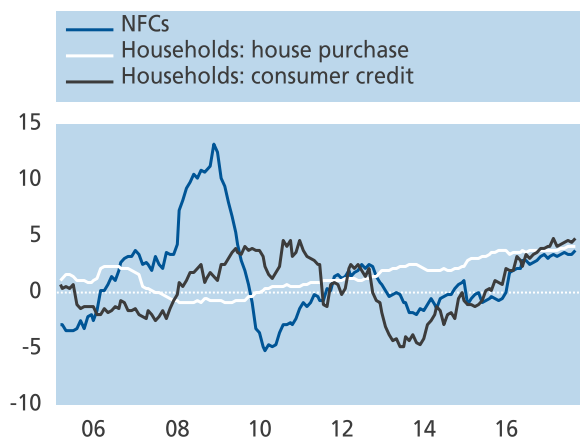
Chart 9: Loans to households for house purchase

Rebased (2004=100)



Source: Thomson Reuters Datastream, TS Lombard, ECB

Chart 10: German bank lending by type (% y/y)



Source: Thomson Reuters Datastream, TS Lombard, ECB

Germany: on a different path

Mortgage lending in Germany gradually rising...

Chart 9 also highlights the radically different trajectory of mortgage lending in Germany compared to the periphery. It was flat during the 2000s (a legacy of the excesses generated during the unification boom) and has been on a gentle upward trend over the past few years. Across sectors, growth rates in German bank lending have been picking up but rather gradually (Chart 10).

... despite relatively high house price inflation

Given ultra-low interest rates and with a construction boom in train, house price inflation in Germany is likely to continue to run at a relatively fast pace compared to post-boom euro area countries. In contrast to the latter, Germany's asset price inflation is not being accompanied by a ramping up of debt – not so far anyway.

Markets: GBP – mind the gap?

- 7-2 BoE vote less of a surprise than more-hawkish tone in statement
- Structural short GBP position being squeezed out
- But UK likely to suffer financial outflow on ECB taper

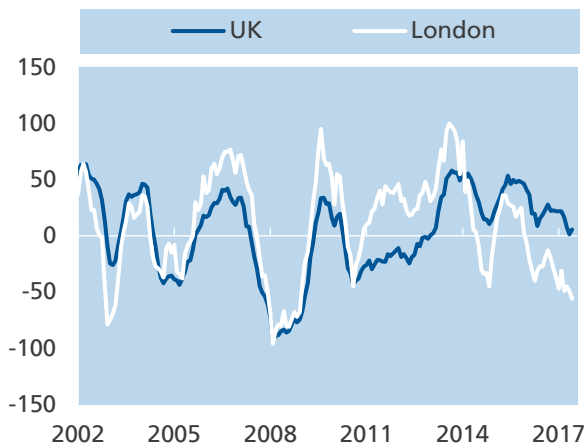
BoE seeing improving activity

The Bank of England’s monetary policy summary this month struck a more hawkish tone than in August. It stated that UK GDP growth has improved slightly and that, because of the fall in potential growth due to Brexit, spare capacity would be absorbed sooner than expected and inflation is expected to overshoot. The August statement equated the inflation overshoot entirely to the fall in sterling; this month the central bank suggested the overshoot is activity driven, justifying an earlier removal of some policy accommodation. Carney’s interview and Vlieghe’s speech (“*The evolution of the data is increasingly suggesting that we are approaching the moment when bank rate may need to rise*”) confirms the view change of the committee’s core members.

But confidence data remain fragile

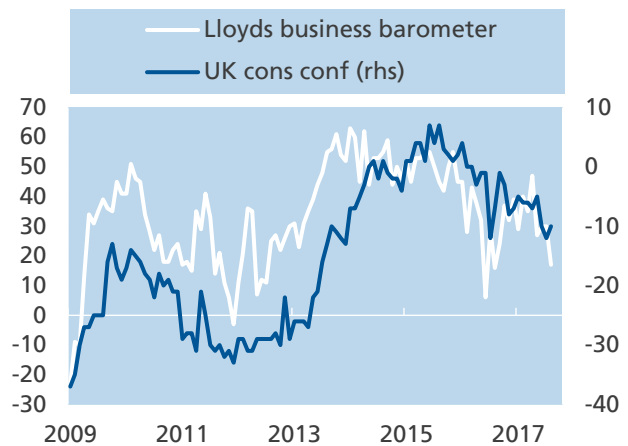
We are not bearish on the UK, as Michelle Lam outlined in her recent Daily Note, “Don’t underestimate the BoE’s hawkishness”. But we expect hikes in 2018 as fading import price pressures lift real wages rather than in anticipation of such an event. Meanwhile the RICS house price balance data (a diffusion index; negative indicates more surveyors expect a fall in prices than expect a rise) suggests further slowdown in London, the ripple effect suggests a national slowdown in the future and business confidence is falling. The Bank of England’s anticipated trade-off between household spending growth and other components of demand is still weak. Even if the central bank justifies a hike as a removal of the 25bp Brexit cut, it is still a tightening of monetary policy into a fragile market.

RICS London balance lowest since 2008



Source: RICS

Business and consumer confidence are falling



Source: Lloyds, Bloomberg

Nevertheless, the hawkish tone came as a surprise and the sterling FX and rates markets were unprepared. Interest rate futures now price a 75% chance of a rate hike this year (up from 20% just last week) and a

Short squeeze driving GBP higher

similar chance of interest rates being above 0.5% by the end of next year. On the currency, investors have been adding to short positions over the summer and there has been no meaningful clear-out of shorts since the Brexit vote. This week's high CPI print started the sharp GBP rally and underlying USD weakness and EUR consolidation helped the currency break through key levels in GBP/USD and EUR/GBP. In April-May 2015 there was a similar short-GBP position squeeze and GBP/USD rallied 8%. This squeeze has already delivered a 6% move but until there is evidence of positioning moving back to neutral it is unwise to fade.

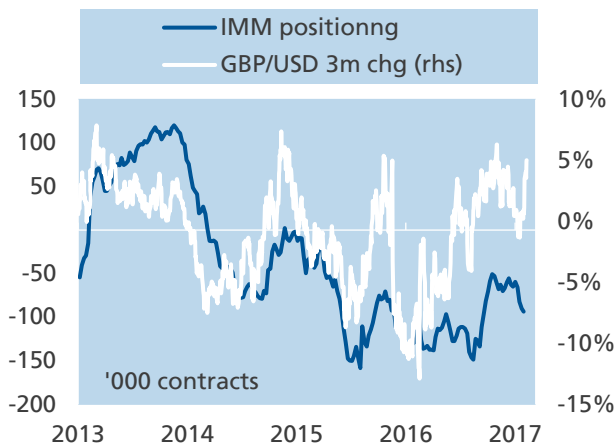
Funding the UK's c/a deficit remains a structural problem

Why fade the move rather than follow the momentum? We have written previously about the balance-of-payments-driven bullish driver for EUR during the ECB's taper, and the flip side of this is outflow from the UK. The UK's broad basic balance of payments has already turned negative. The UK has never struggled to fund its current account deficit, historically thanks to petrodollar recycling during the oil boom and safe-haven rule-of-law inflows during various recent crises. But with the loss of ECB-driven portfolio inflows and the likely normalisation of euro area government bond yields, investors into the UK must be better-compensated for their inflow. This is either through a weaker currency (to discount assets for foreigners) or higher yields. Perhaps there is an element of anticipating the ECB's taper in the Bank of England's hawkish move.

Look to long EUR/GBP once the squeeze momentum fades

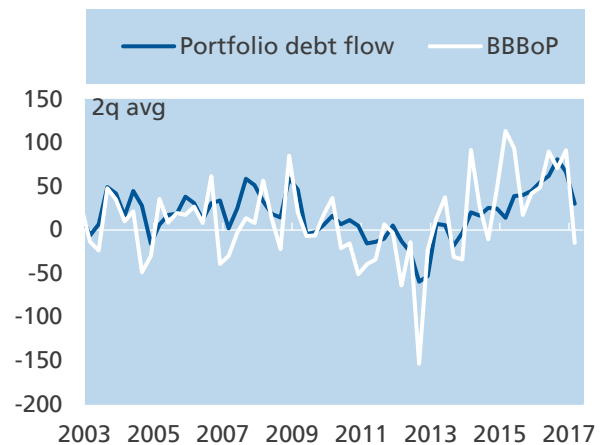
In the Macro Strategy portfolio, and in Monday's Daily Note on the outlook for the euro, we have discussed our expectations of short-term consolidation in EUR before renewed strength in H1 next year. This rally in GBP will provide a great entry level for a long EUR/GBP taper trade next year. While the short squeeze continues there is no rush to put the trade on but if the next round of UK data suggests the Bank of England's hawkish tone is unwarranted, EUR/GBP is the best vehicle to trade the potential policy mistake.

GBP short position squeeze



Source: CFTC, Bloomberg, TS Lombard

Balance of payments is bearish GBP



Source: Bank of England, TS Lombard

Politics: A Catalan stand-off

- Catalonia plans to hold a vote on independence on October 1st
- But Madrid is determined to prevent a Catalan secession
- Catalonia will not leave Spain, although the row could be protracted

Catalonia plans to hold a referendum on independence on October 1st...

On October 1st, the Spanish region of Catalonia will hold a referendum on secession – and if the population votes to leave, it will declare independence within 48 hours. That, at least, is the plan set out by the narrow separatist majority in the Catalan parliament, and that brought the crowds out into the street on Monday for the Catalan national day.

Of course, the secession of Spain's wealthiest region would be intensely disruptive – not least because the regional government is dependent on Madrid for the liquidity it needs to service its €6bn debt, and because the sustainability of Spain's own national debt would depend on the proportion allocated to a hypothetically independent Catalonia. But Spanish and Catalan debt markets have so far been relatively subdued.

Not going anywhere

...but the region will not secede, as Madrid has no intention of allowing it to do so

The reason for this, presumably, is that the markets don't expect Catalonia to secede from Spain any time soon. They're right: Madrid won't allow it. The governing conservative PP has no intention of ceding any ground to the separatists, and it has the backing of the opposition centre-left PSOE and the liberal Ciudadanos – as well as that of the country's Constitutional Court, which has temporarily suspended the law instituting the referendum on the grounds that it appears to violate a constitutional clause specifying to Spain's indissolubility. (The passage of the referendum law was also arguably non-compliant with the Catalan government's own statutes). But the Catalan government is ignoring the ruling, and plans to go ahead.

Rajoy's options

Spanish PM Rajoy has vowed to stop the vote – but that might be seen as overreaction

How will Madrid respond? Prime Minister Mariano Rajoy has insisted that he will not allow the vote to take place. Public prosecutors have announced charges against members of the Catalan government, and have instructed the Catalan police force to take steps to disrupt the vote – putting the police in a difficult position, as they also answer to the regional government. If Rajoy is determined to prevent the vote from taking place, he can: Madrid could send in the national police or the army, and could go so far as revoking Catalonia's autonomy.

However, that would likely be received as inflammatory and disproportionate. Indeed, support for independence has been falling in recent years after reaching a peak during the euro crisis, and we think one possible rationale for the Catalan government's current drive for independence is to provoke a heavy-handed response from Madrid that turns moderate Catalan opinion against them.

An alternative would be for the anti-independence faction to boycott the vote, and ignore its result

An alternative would be for Rajoy to allow the vote to take place, but for the anti-independence parties to renew their calls for their voters – and as far as possible, the municipalities they control – to boycott the vote. Opinion polls already show that, while a majority of Catalan voters oppose independence, enough of them would refuse to turn out for the separatists to win.

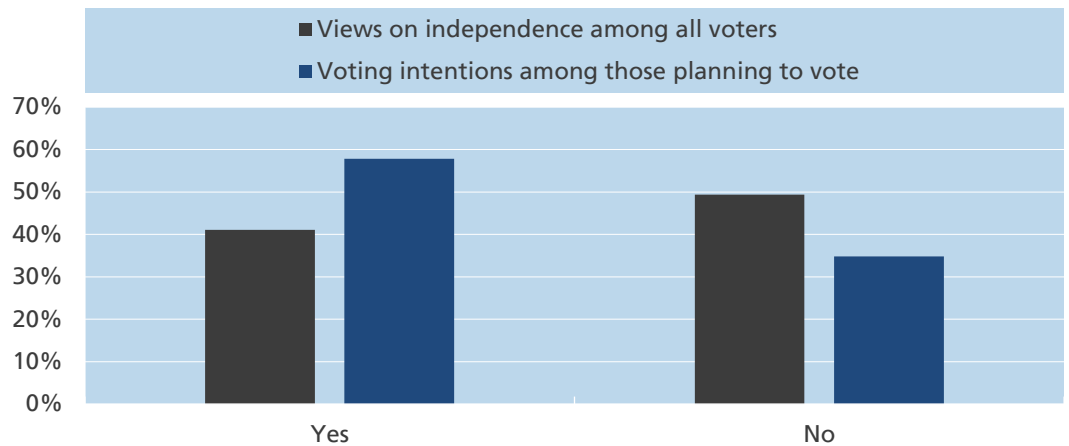
Rather than try to prevent the vote, Rajoy could simply refuse to recognise it; and when it registers a Soviet-style majority for independence on a derisory turnout, congratulate the Catalan government on having conducted a glorified survey of its own supporters. It would then be any declaration of independence which would seem illegitimate and divisive. A messy dispute might result, but with economic and hard power and international recognition vested in Madrid, the outcome would not be in doubt.

Room to compromise, eventually?

But fiscal autonomy for the region will likely come back on the table as part of any compromise

Ultimately, the way out of the impasse might be for both parties to return to the negotiating table. Although Rajoy’s previous intransigence on Catalan requests for additional autonomy are a major factor behind the current push for independence, he now appears to be open to Basque-style fiscal autonomy for the region – a longstanding demand. (The opposition PSOE is in favour of amending Spain’s Constitution to create a federal state, but this is unlikely to get off the ground any time soon). In the meantime, though, the resolution of the current stand-off may be messy – but its outcome isn’t in doubt.

Separatists more likely to vote



Source: GESOP/CEO poll, 11/07/2017