

# ECB Succession Watch

## ECB presidency: Race wide open

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- Outlook:** Given expectations for a Federal Reserve cut, we now expect the ECB to remove the tightening bias from its forward guidance on 25 July and no longer expect a rate hike in 2020. Meanwhile, failure to agree on the European Commission presidential candidate by the heads of state on 20 June has leveled the playing field between Jens Weidmann and the other major candidates for Draghi's succession. However, uncertainty is very high. What's more, the forthcoming change in the ECB's forward guidance is set to impede monetary tightening until June 2020, even if Weidmann gets the ECB presidency.
- Markets:** Despite the negative impact of trade tensions on the economy, we expect the euro to appreciate slowly against the US dollar given the ECB's more limited policy space. Meanwhile, with a more hawkish ECB executive board, peripheral bond and equity markets may show greater sensitivity to adverse macro news than in the past.
- What we are watching:** European Council meeting on 30 June, Brexit, European Parliament coalition building and first sitting on 2 July.



Source: iStock

### Related Research

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Source: UBS

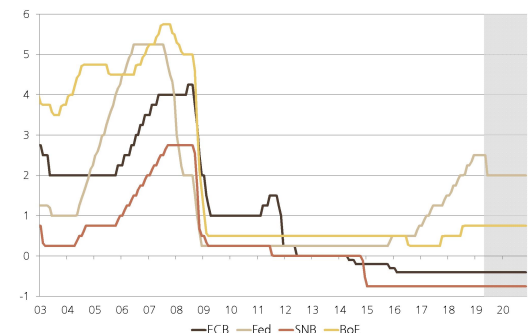
### Our view

The European Council of 20 June sought to nominate the new presidents of the European institutions, including the ECB's. However, no Spitzenkandidat for the European Commission got a majority among the heads of state. This means that all options remain on the table for the European presidencies, including that of the ECB. More importantly, failure of Germany's Manfred Weber to be nominated for the European Commission presidency has leveled the playing field among the main ECB candidates. These include France's Villeroy, Germany's Weidmann and the Finnish compromise candidates.

We think that Weidmann leading the ECB would have the biggest market impact. However, the ECB adopting an easing bias and the Federal Reserve on course for cutting interest rates is likely to result in the ECB to change its forward guidance on 25 July. This would make it hard for any new president to quickly change course. Nonetheless, the ECB president is normally appointed for an 8 year term, so in the long-term it would still make a difference. At this juncture, we think the chance of Weidmann, Villeroy or the Finnish compromise candidates being appointed as ECB president are about even. The plan is now to agree on the European nominations on 30 June, but a material risk remains that it may be delayed even after the European parliament's first sitting on 2 July.

**Fig. 1: Central bank policy rates (%)**

Federal Reserve expected to cut



Note: ECB policy rate represented by deposit rate. Source: Haver Analytics, UBS, as of 21 June 2019

## Questions and answers

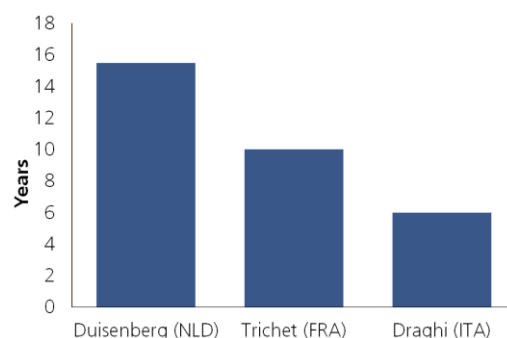
### Who are the frontrunners for the ECB succession?

Eurozone member states are each able to put forward one candidate (through the respective head of state), though none has done it so far (and likely only a few will). The key contenders currently include:

- **Jens Weidmann** (Germany): The former Angela Merkel advisor and Germany's frontrunner would probably start the rate hike process earlier than the others to create monetary policy space for a future recession. He may also seek a small balance sheet in normal times, and is critical of sovereign asset purchases. His candidacy lost momentum last year when Merkel started to focus on the European Commission presidency. French President Emmanuel Macron is said to consider Michel Barnier for European Commission president. In this case, the ECB presidency would be Germany's main target, unless Merkel grabs the European Council or Commission presidency for herself. Germany has never held the top ECB job, while France already has in Jean-Claude Trichet.
- **François Villeroy de Galhau** (France): The Banque de France governor is France's frontrunner and also enjoys some support in Germany given his German roots and language skills. Villeroy de Galhau held various posts in the French administration, including at the treasury and finance ministry. He has a dovish and pragmatic tilt and has stuck close to Draghi's line of stimulus, even if he pushes back against debt monetization ideas. However, his past position at a French bank could make the ECB more sensitive to the banking sector and move rates back to zero more swiftly, if he became president. In addition, he has argued for a large balance sheet even in normal times.
- **Benoît Coeuré** (France): Although he is very highly regarded, Coeuré's nonrenewable term as ECB executive board member runs until the end of 2019. We are skeptical that the legal hurdles to appointing him can be overcome. Although he was one of the architects of the QE program, having started his term along with Draghi in 2011, he is generally not an advocate of pre-commitments and forward guidances.
- **Erkki Liikanen** (Finland): The former Governing Council member is a seasoned veteran and was an independent thought leader within the ECB. He is a good networker with statesman qualities and his monetary approach is balanced. Some observers believe that France could also support a Finnish ECB president. Liikanen's party (Social Democrats) won the most seats in the recent elections (nine more than compatriot Olli Rehn's Center Party). This could play to his advantage against Rehn.
- **Olli Rehn** (Finland): The Governing Council member joined the ECB only in mid-2018. He was in charge of the euro as EU commissioner during the debt crisis, being a strong advocate of fiscal discipline. Just like Liikanen, his political past has helped him develop statesman qualities. His fiscal stance could make a difference for Germany, if France and Germany were to compromise on a non-French and non-German candidate. In addition, he is spearheading the first rethink since 2003 of the ECB's monetary strategy (subject to the Federal Reserve's own rethink in 1H20) and has argued for inflation-targeting. He is one of the few active Twitter users in the Governing Council.

Given the European elections and Brexit, uncertainty is high at this point and the frontrunners could change at a short notice. Other contenders include Klaas Knot (Netherlands), Pablo Hernandez de Cos (Spain), Klaus Regling (Germany), Ardo Hansson (Estonia), and Christine Lagarde (France).

**Fig. 2: First three ECB presidents**  
Years of experience as national central bank chief



Source: UBS.

### **What is our baseline view on the ECB succession?**

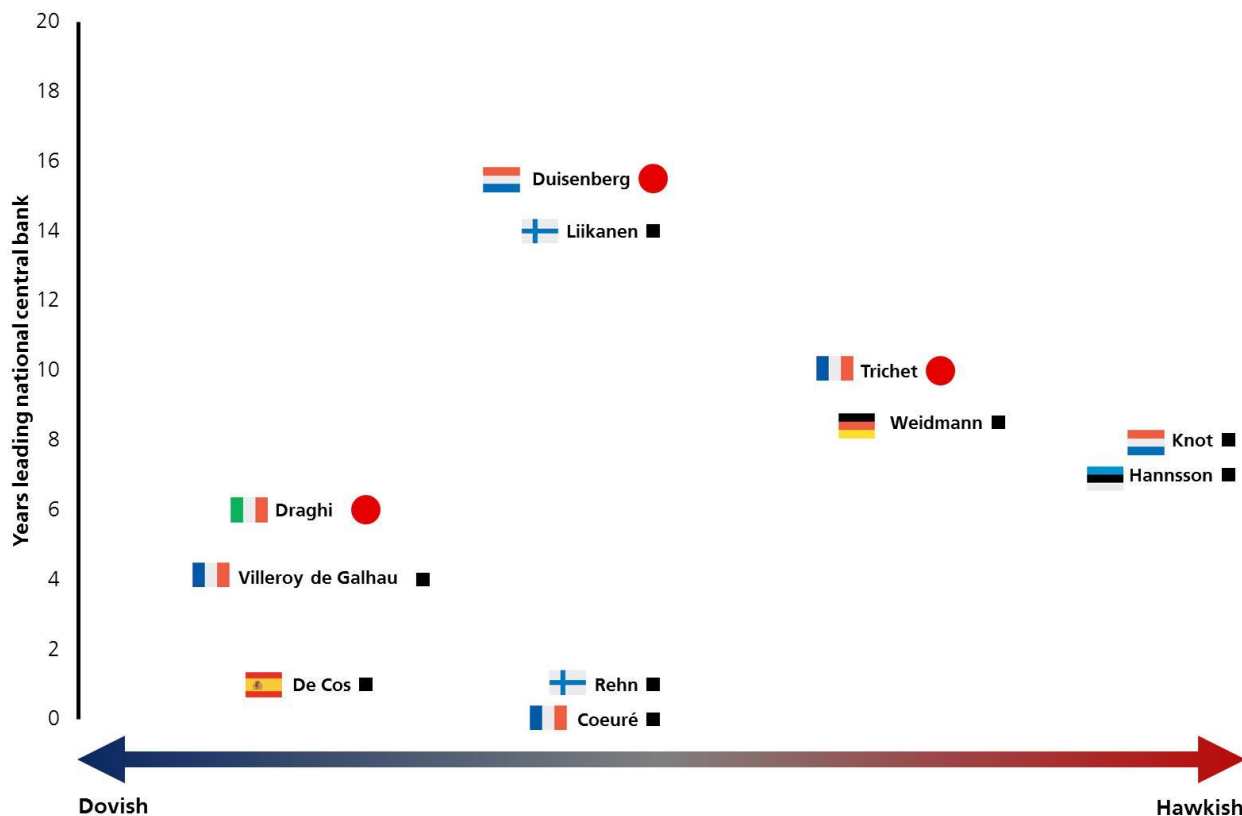
We think that politically, determining the new European Commission president will take precedence over the ECB presidency this time, especially with the ascent of protectionism (the European Commission takes the lead in trade negotiations). Accordingly, the ECB succession will depend on the appointment of the European Commission president. In addition, we believe France and Germany will each aim to place a candidate of their choice (not necessarily of French or German nationality) either at the ECB or the EU Commission, with Germany in particular prioritizing the commission presidency. In such an event, the Finnish compromise candidates Liikanen and Rehn and in particular France's Villeroy de Galhau would be best positioned to be ECB president, although it is still very early days and names can change at a short notice. Conversely, if Germany does not get the European Commission presidency, Weidmann may be best positioned for the role of ECB chief (unless Merkel goes herself for the European Council or Commission presidency). This is because he is the only German frontrunner, as well as the only key candidate of a country run by a head of state from the European center-right (European People's Party). Given the inability of the European Council to agree on the nomination on 20 June, we think that chances are about even between Villeroy, Weidmann and the Finnish compromise candidates.

### **How do the candidates compare to prior ECB presidents?**

One thing all ECB presidents so far have in common is that they led their national central banks (for 10 years on average, see Fig. 2). In our view, the technical and management experience gained from such a position is more important than ever, because the ECB's staff, influence, and responsibilities have increased substantially since 1999. Accordingly, we think that candidates who have run a national central bank have an edge in the process. Certainly, years of experience running a central bank are a mere proxy for the skill set required of a candidate for ECB president, but they are in any case part of the debate. In Fig. 3 we go one step further and combine this proxy with our own assessment of how dovish or hawkish the candidates with central bank leadership experience are compared to the first three ECB presidents. Surprisingly, the top three candidates in most surveys (Weidmann, Villeroy, Liikanen) are fairly close in policy leanings to the prior presidents. Villeroy has similarities with Draghi, Liikanen with Duisenberg, and Weidmann with the hawkish Trichet. These profiles are far apart from each other. Draghi, for example, has not raised interest rates in his eight years as president, and even added multiple accommodative tools such as quantitative easing. Trichet raised interest rates in 2005 against the wishes of almost all member states, in 2008 during the global financial crisis, and again in 2011 just before the Eurozone entered recession. Duisenberg in turn was rather inconspicuous compared to the other two presidents. Investors are therefore well advised to closely follow the appointment process in June.

**Fig. 3: CIO ECB succession radar**

The top three candidates (Weidmann, Villeroy, Liikanen) have similarities with prior ECB presidents



Sources: UBS, Bloomberg. Note: Names can change at short notice and exclude non-central bankers such as Christine Lagarde or Klaus Regling. Note: Dovish/Hawkish assessment based on quotes from central bankers, interviews and Bloomberg ECB spectrometer.

**Eurozone bonds: Implications from ECB presidency and European elections?**

German Bund yields have fallen further and reached all-time lows. Sovereign bond risk premiums were unmoved by the European Parliament election outcome in most Eurozone countries. The exceptions were those of Italy and Greece, which moved in opposite directions. Greek bonds gained after Prime Minister Alexis Tsipras announced he would call snap elections as soon as possible following his party's defeat in the EU poll. We caution, however, that a new government led by the New Democracy party would not necessarily result in better fiscal performance.

Italian bonds suffered as the right-wing Lega party gained most votes. Although no new elections have been announced in the country as a result, Lega is the government's junior but managing coalition partner with M5S. We expect the process of drafting a 2020 budget plan in autumn to be difficult. Lega officials are set to challenge EU budget rules, but will come up against new EU Commission members likely keen on demonstrating their ability to enforce the fiscal stability mandate. The resulting public stand-off may lead to higher and more volatile risk premiums for Italian bonds along with the possibility of escalating conflict, as was the case last year.

The choice of president for the European Central Bank (ECB) could also heighten bond markets' sensitivity to political news. If Jens Weidmann is chosen, yields and spreads would most likely shift higher at first. Lower-rated countries that have benefited greatly from ECB bond buying could experience rising bond yields, as Weidmann has often criticized this policy measure. Italian bonds, in particular, look most vulnerable to adverse political news if the established "Draghi backstop" is questioned. A mere continuation of current policies, as might be expected if France's François Villeroy becomes ECB president, should not shift most Eurozone government bond yields much, as valuations already reflect a very dovish monetary policy stance, in our view. But investors would likely assume that even the most dovish candidate may not support Italian banks and government bonds as effectively as Draghi has done, resulting in greater sensitivity to adverse economic or political news.

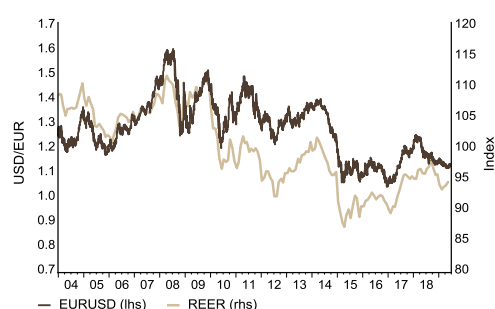
### ECB presidency: What are the implications for Eurozone equities?

There are many moving parts driving Eurozone equity markets, not least of all geopolitical uncertainty, especially US-China trade tensions and, to a lesser extent, Brexit. This adds to the conventional drivers, such as earnings momentum, valuations and central bank policies, including the Fed's. The ECB's exceedingly loose monetary policy might be called into question if Jens Weidman were to be chosen as the new ECB president. If his appointment leads to higher Eurozone rates and greater risk premia for lower-rated countries, this could have an adverse effect on EMU equities; Eurozone banks would benefit, however. But even more dovish candidates may exhibit a more conservative stance to the periphery, which would hamper their equity markets. Moreover, a rising euro would have an adverse impact on MSCI EMU's EPS growth because non-euro revenues would be worth less when translated into euros; around 50% of Eurozone companies' revenues are generated outside the euro area. A lasting 5% rise in the trade-weighted euro would reduce EPS, on average, by 2–3%. Countries with above-average forex exposure, such as Germany and the Benelux, would be most affected.

### How might the currency react to a new ECB president?

First impressions are not everything. The president is the *primus inter pares* when voting on big decisions and usually leads the consensus on controversial issues. From that perspective, the majority matters more than the head. Still, the personality and the character of the president make a difference, and we should not underestimate the impact Draghi had on the euro during his term. His name will always be closely connected to the weakness of the euro triggered by quantitative easing, and the idea that the ECB will do "whatever it takes" to safeguard the Eurozone. At first, the change from Draghi to a new leader is likely to strengthen the currency almost by definition. Anyone stepping in his big shoes will find it difficult at first to convince markets that he is as strong and committed as his predecessor. We suspect that markets, when in doubt, would rather buy than sell the euro. Now, it is more difficult for the ECB to find new means to expand monetary policy than it is to tighten. Market perception of risks could therefore turn hawkish, especially as the next generation of the Executive Board will likely be more hawkish. With the new president getting settled, it seems clear that Weidmann, being more conservative, will promote policies that strengthen the euro more than it would under the other two top candidates (i.e. Villeroy or Liikanen). For this reason, we could also see a tendency that the euro reacts positively to those two candidates, at least in an initial phase.

**Fig. 4: EURUSD vs. trade-weighted euro**  
Trade-weighted exchange rate consolidating



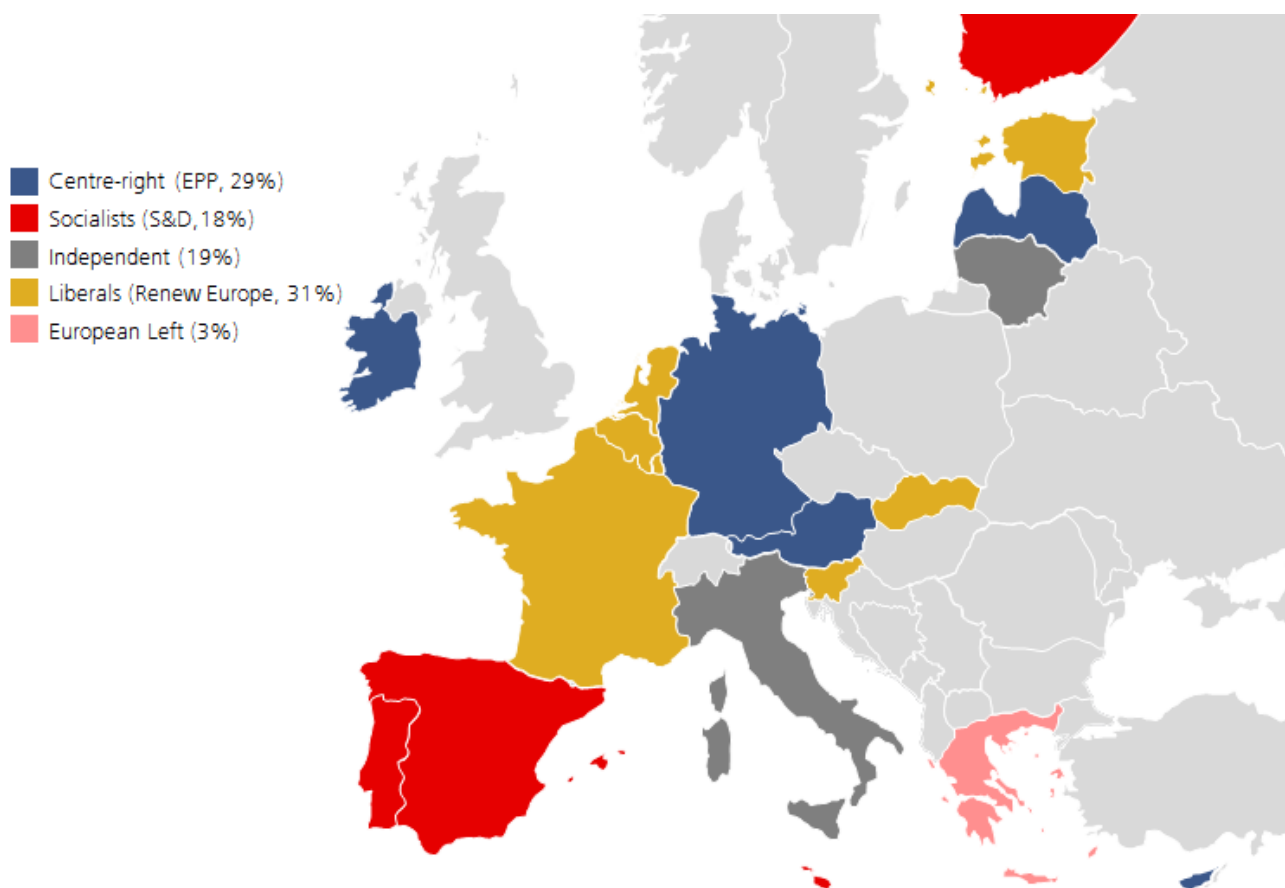
Note: REER = Real effective exchange rate. Source: Haver Analytics, UBS, as of 19 June 2019.

### What is the link between politics and the ECB presidency?

Typically, decision-making for European appointments revolves around the Franco-German axis as well as the affiliation of the 19 heads of state to the respective European party family. The political heat map (Fig. 5) shows all voting countries and the membership of the respective head of state in the European party families. The center-right (i.e., EPP) will mathematically not be able to push through the ECB presidency on their own. Beyond Spain, Germany will need the support from either France or Italy. France will likely only play ball if they get either the ECB presidency or European Commission presidency. Italy's priority is to be properly represented in European institutions. We believe that taking the European parliament presidency in July could fit that purpose.

**Fig. 5: Heads of state behind ECB presidency decision**

Fragmented political landscape hindering ECB nomination (share of Eurozone population in brackets)



Source: UBS, as of 20 June 2019

Note: EPP = European People's Party, S&D = The Progressive Alliance of Socialists and Democrats. Belgium is forming a new government.

### When is the ECB president elected?

We believe the ECB president will be determined after it is clear who will become the European Commission president. Following the European elections, the president of the European Council, Donald Tusk, will consult the European Parliament in June on the European Commission presidency. The European Council aims to formally decide on its proposal for the Commission presidency on 30 June, while the European

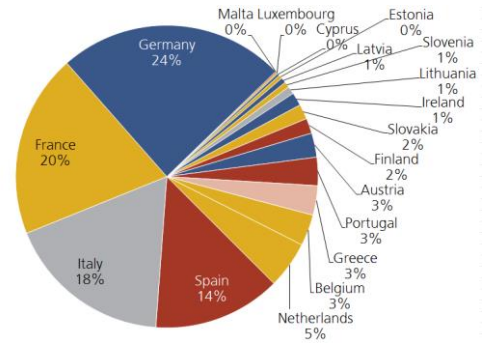
Parliament will elect the European Commission president in early July, most likely on 2 July. However, given the fragmentation in European politics, it could easily take longer.

**How is the ECB president elected?**

To become ECB president, Article 283 of the Treaty of the European Union applies. Under Article 283, a candidate is appointed by the heads of the member states (for a nonrenewable eight-year term). The heads of state need to consult with the European Parliament and the ECB Governing Council before making an appointment. Nonetheless, the ultimate decision-making power lies with the Eurozone heads of state within the European Council, based on "reinforced qualified majority." This requires that at least 72% of member states (i.e., 14 out of 19 members) and member states representing at least 65% of the population of the Eurozone to approve it (see Fig. 6 for weights). As such, each member state (through its head of state) has the right to put forward one candidate. Normally however, very few countries (or sometimes only one) put forward a candidate, because only a few candidates have a realistic chance of winning.

**Fig. 6: Eurozone population weights**

German dominance



Source: UBS, as of 20 June 2019

Note: blue = EPP, grey = independent, red = S&D, yellow = Renew Europe, light red = European Left, green = Greens. Belgium is forming a new government.

## Appendix

### Terms and Abbreviations

Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
1H, 2H, etc. or 1H11, 2H11, etc.	First half, second half, etc. or first half 2011, second half 2011, etc.	1Q, 2Q, etc. or 1Q11, 2Q11, etc.	First quarter, second quarter, etc. or first quarter 2011, second quarter 2011, etc.
2011E, 2012E, etc.	2011 estimate, 2012 estimate, etc.	A	actual i.e. 2010A
ADR	American depository receipt	ARPU	Average Revenue Per User
AUM	Assets under management = total value of own and third-party assets managed	Avg.	average
BCOM	Bloomberg Commodity Index	bn	Billion
bp or bps	Basis point or basis points (100 bps = 1 percentage point)	BVPS	Book value per share = shareholders' equity divided by the number of shares
CAGR	Compound annual growth rate	Cant Inc/Capita	Cantonal income per capita (Switzerland only)
Capex	Capital expenditures	CF	Cash flow
CFO	1) Cash flow from operations, 2) Chief financial officer	COGS	Cost of goods sold
COM	Common shares	Cons.	Consensus
Core Tier 1 Ratio	Tier 1 capital minus tier 1 hybrid securities	Cost/Inc Ratio (%)	Costs as a percentage of income
CPI	Consumer price index	CR	Combined ratio = ratio of claims and expenses as a percentage of premiums (for insurance companies)
CY	Calendar year	DCF	Discounted cash flow
DDM	Dividend discount model	Dividend Yield (%)	Dividend per share divided by price per share
DPS	Dividend per share	E	expected i.e. 2011E
EBIT	Earnings before interest and taxes	EBIT Margin (%)	EBIT divided by revenues
EBITDA	Earnings before interest, taxes, depreciation and amortization	EBITDA Margin (%)	EBITDA divided by revenues
EBITDA/Net Interest	EBITDA divided by net interest expense	EBITDAR	Earnings before interest, taxes, depreciation, amortization and rental expense
EFVR	Estimated fair value range	EIA	Energy Information Administration
EmV	Embedded value = net asset value + present value of forecasted future profits (for life insurers)	EPS	Earnings per share
Equity Ratio (%)	Shareholders' equity divided by total assets	EV	Enterprise value = market value of equity, preferred equity, outstanding net debt and minorities
FCF	Free cash flow = cash a company generates above outlays required to maintain/expand its asset base	FCF Yield (%)	Free cash flow divided by market capitalization
FFO	Funds from operations	FY	Fiscal year / financial year
GDP	Gross domestic product	Gross Margin (%)	Gross profit divided by revenues
H	half year	h/h	Half-year over half-year; half on half
hist av.	Historical average	Interbank Ratio	Interbank deposits due from banks divided by interbank deposits due to banks
Interest Coverage	Ratio that expresses the number of times interest expenses are covered by earnings	Interest exp	Interest expense
ISIN	International securities identification number	K	One thousand
LLP/Net Int Inc (%)	Loan loss provisions divided by net interest income	LLR/Gross Loans (%)	Loan loss reserves divided by gross loans
LPR	Least Preferred: The stock is expected to both underperform the relevant benchmark and depreciate in absolute terms.	Market cap	Number of all shares of a company (at the end of the quarter) times closing price
m/m	Month-over-month; month on month	mn or m	Million
M and A	Merger and Acquisition	MP	Marketperform: The stocks expected performance is in line with the sector benchmark
MPR	Most Preferred: The stock is expected to both outperform the relevant benchmark and appreciate in absolute terms.	n.a.	Not available or not applicable
NAV	Net asset value	Net Debt	Short- and long-term interest-bearing debt minus cash and cash equivalents
Net DPS	Net dividends per share	NIM or Net Int Margin (%)	Net interest income divided by average interest-bearing assets
Net Margin (%)	Net income dividend by revenues	NV	Neutral View: The stock is expected to neither outperform nor underperform the relevant benchmark nor significantly appreciate or depreciate in absolute terms.



## Appendix

Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
n.m. or NM	Not meaningful	NPL	Non-performing loans
OP	Outperform: The stocks is expected to outperform the sector benchmark	Op Margin (%)	Operating income divided by revenues
p.a.	Per annum (per year)	P/BV	Price to book value
P/E or PE	Price to earnings / Price Earnings Ratio	P/E Relative	P/E relative to the market
P/EmV	Price to embedded value	PEG Ratio	P/E ratio divided by earnings growth
PPI	Producer price index	Prim Bal/Cur Rev (%)	Primary balance divided by current revenue (total revenue minus capital revenue)
Profit Margin (%)	Net income divided by revenues	q/q or QQQ	Quarter-over-quarter; quarter on quarter
R and D	Research and development	ROA (%)	Return on assets
ROAE (%)	Return on average equity	ROCE (%)	Return on capital employed = EBIT divided by difference between total assets & current liabilities
ROE (%)	Return on equity	ROIC (%) or ROI	Return on invested capital
Shares o/s	Shares outstanding	Solvency Ratio (%)	Ratio of shareholders' equity to net premiums written (for insurance companies)
sotp or SOTP	Sum of the parts	Tax Burden Index	Swiss tax index; 100 = average tax burden of all cantons
tgt	Target	Tier 1 Ratio (%)	Tier 1 capital divided by risk-weighted assets; describes a bank's capital adequacy
tn	Trillion	UP	Underperform: The stock is expected to underperform the sector benchmark
Valor	Swiss company identifier	WACC	Weighted average cost of capital
WPIC	World Platinum Investment Council	CIO	UBS WM Chief Investment Office
x	multiple / multiplicator	y/y or YOY	Year-over-year; year on year
yr	Year	YTD	Year-to-date

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