

European Equities Under Pressure: Sector Rotation, Banking Resilience, and Portfolio Repositioning Amid Geopolitical Risk

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- Banking resilience comes under short-term pressure.**
 European banks remain fundamentally strong, but rising volatility and weaker risk appetite have pushed the sector lower in the short run.
- Geopolitical tensions are driving market rotation.**
 Higher oil prices and Middle East tensions have encouraged investors to move away from cyclical sectors and toward areas seen as safer or better positioned.
- Asset managers are reducing risk selectively.**
 Recent fund flows and hedging activity suggest investors are rebalancing portfolios and trimming exposure rather than fully exiting equity markets.

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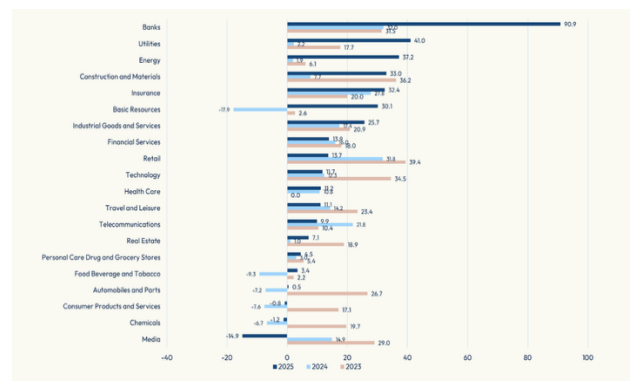
Section 1: Strong Fundamentals Confront Geopolitical Headwinds: European Banks Amid Risk-Off Rotation

Historic European banking outperformance amid solid fundamentals of sustained profitability and capital adequacy.

Geopolitical developments in the Middle East are amplifying market volatility and influencing investor behavior, driving broad risk-off rotation across sectors. Despite current market disruptions, the medium-term outlook for European banks remains constructive. Strong balance sheets, earnings leverage and potential benefits of ECB monetary policy adjustments shield against market stress.

In 2025, the EURO STOXX Banks Index, a key proxy for the European banking sector, delivered a historic rally, advancing by 80.3% and significantly outperforming prior sector cycles. This marked the strongest annual performance in the index’s history. The surge reflected a combination of robust NIMs, allowing profits from deposit rates standing below loan rates, alongside resilient balance sheets. Capital adequacy remained strong, with the Common Equity Tier 1 ratio of the sector averaging at 16.3%, underscoring the abilities of European banks to absorb financial stress if need be.

Figure 1: EURO STOXX Super sectors’ performance – Euro Banks beat all other 19 ICB super sectors for a second consecutive year



Source: STOXX. Gross returns in EUR through December 31, 2025.

Momentum was anticipated to exhibit this performance in early 2026, and it did so as expected. The index experienced a 52-week peak on the 3rd of February, a 31% increase over the preceding 12 months.

Escalating March Mideast tensions, however, are triggering the sharpest drawdown of the sector in months; EURO STOXX Banks experienced a 9.6% YTD decline and a 0.97% decline in the past week, showcasing deterioration in investor sentiment and risk appetite.

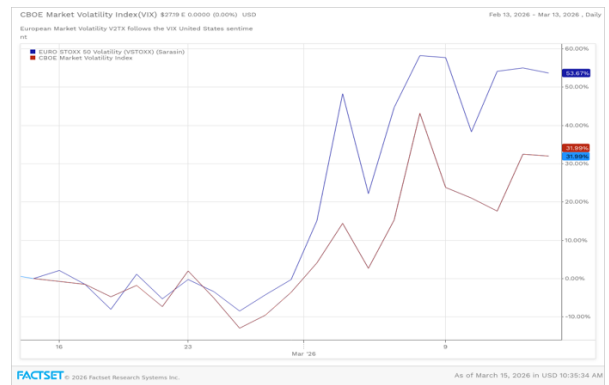
The sell-off coincides with a spike in crude. Brent Oil has been trading at above \$100 per barrel for 2 consecutive sessions as the United States intensifies military strikes on Iran. Hiked oil prices are becoming interpreted by markets as a potential inflationary catalyst, fueling expectations that the ECB may pivot from standby to a hawkish monetary stance. Whether these suppositions hold will only come to light on the 19th of March, with the ECB's Governing Council meeting on rates, which would shape near-term expectations for interest rates.

Another factor weighing on Europe's banking sphere is the risk-off rotation across equity markets, with investors reducing exposure cyclicals and reallocating capital towards global defense and energy stocks, showing themselves to be the beneficiaries of geopolitical instability and higher commodity prices. Shares of Britain's BAE Systems defenses and BP report gains of 0.39% and 1.21% respectively in recent sessions, trailing the intense gains both companies have recorded in the past few weeks.

Data reported by Reuters shows that banks have absorbed the largest share of the sell-off, with STOXX Europe 600 Bank Index price return falling by 3.2%, and heavyweights HSBC, Santander seeing drops between 3% to 5% in the few days following the 28th of February strike.

Market anxiety has been reflected in derivatives markets, with the Euro STOXX volatility index (V2TX) experiencing its highest level since mid-November. Naturally, this shows the ripples of global volatility that has reached Europe – the VIX showed a 81.9% jump in this year to date, and the European and US volatility move in sync. These send signals elevated hedging demand and heightened investor certainty.

Figure 2: European market volatility V2TX follows the VIX United States sentiment



Source: FactSet

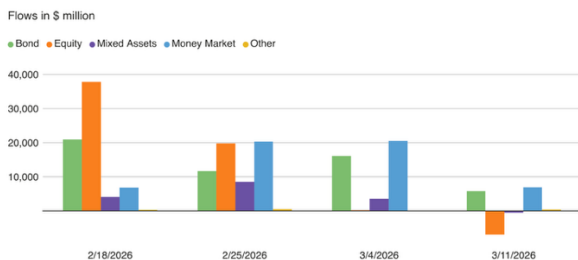
Going forward, it is crucial that markets closely monitor the ECB's rate meeting, Iran-US military interactions, and the trajectory of Brent Oil crude prices. Despite near-term volatility, the medium and long-term outlook for European banks remains constructive, and a bullish stance could be valuable, supported by improving profitability, strong capital buffers and sustained earnings leverage from higher interest-rate environments.

Section 2: Asset Managers Trim Equity Exposure and Reposition Portfolios

Alongside the volatility seen across European banks, the past week has also brought noticeable repositioning among global asset managers within equity markets. Rather than exiting equities outright, investors have largely been reducing exposure and adjusting positioning following the strong rally in European markets over the past year.

One of the clearest developments has been profit-taking in European equities. Data reported by Reuters shows that European equity funds recorded approximately \$7.7 billion in outflows in the week to 11 March, marking one of the largest weekly withdrawals in recent months. This follows a period in which European equities had attracted strong inflows and substantial investor interest after their powerful performance throughout 2023. For many institutional investors, the recent increase in geopolitical tensions and market volatility has therefore provided an opportunity to lock in gains after the rally, rather than signalling a complete shift away from the region.

Figure 4: Global Equity Fund Flows Turn Negative as Investors Reduce Risk



Source: LSEG

At the same time, the repositioning within equity portfolios has been highly selective. Investors have been rotating between sectors rather than broadly reducing exposure to equities as an asset class. Financial stocks in particular have experienced meaningful selling pressure, with global financial sector funds seeing roughly \$2.3 billion of outflows during the same week. By contrast, other parts of the equity market have attracted fresh capital, with industrial sector funds recording inflows of around \$1.3 billion, reflecting continued investor interest in sectors tied to structural spending themes and industrial activity.

Market movements across European equities illustrate this rotation. During the week, the STOXX Europe 600 index declined roughly 0.6% in one of the more volatile sessions, while bank shares fell significantly more sharply. In contrast, some defensive and industrial segments of the market proved more resilient, highlighting how investors are increasingly favouring companies with more stable earnings profiles during periods of uncertainty.

A third important development has been the rise in hedging activity among asset managers. Volatility indicators across equity markets increased notably over the past week, with the VIX index climbing to around 28, its highest level in several months. In Europe, the Euro STOXX volatility index (V2TX) also moved sharply higher, signalling growing demand for portfolio protection. In practice, this suggests that many institutional investors are choosing to protect existing positions rather than exit them entirely, using hedging strategies to reduce downside risk while maintaining long-term equity exposure.

Figure 3: VIX Rises Sharply as Investors Increase Hedging Activity



Taken together, these developments suggest that the past week has been characterised less by a broad retreat from equities and more by a tactical recalibration of risk. Asset managers are trimming some positions, rotating between sectors and increasing hedges as volatility rises. However, the underlying commitment to equities remains intact, with investors continuing to seek opportunities across sectors even as they adjust portfolios to navigate a more uncertain macro environment.

Sources: Reuters, FREDD, STOXX, ESMA

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