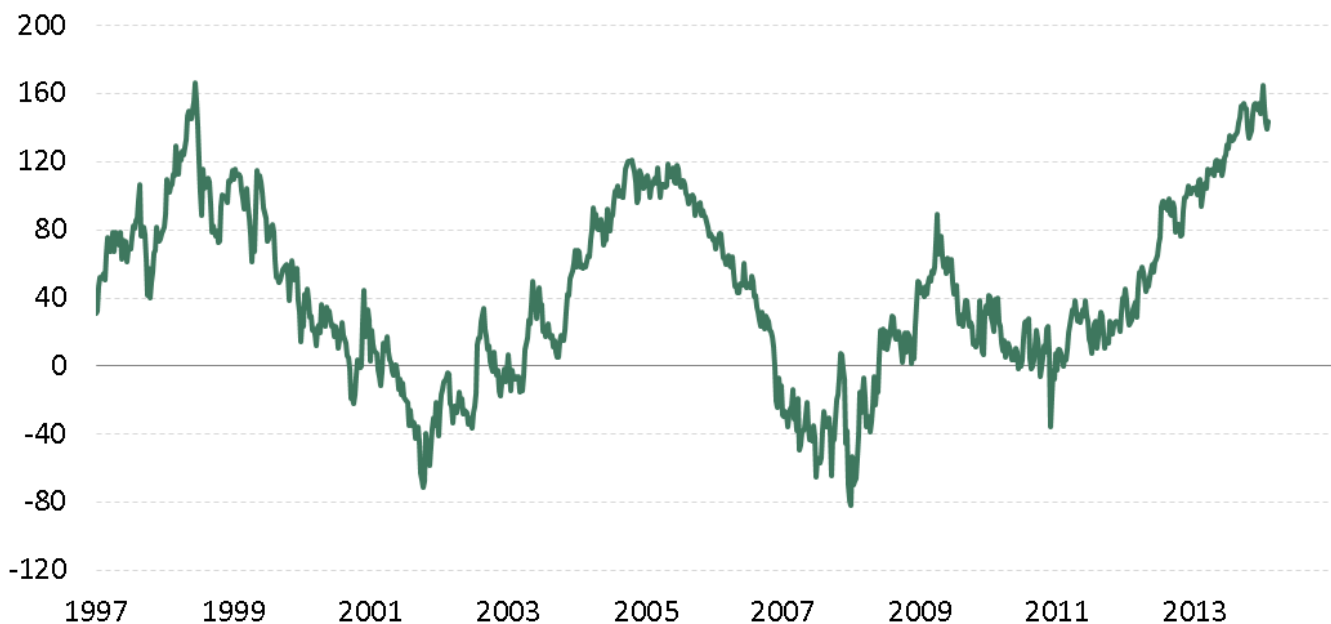


European QE is Not U.S. QE

Francis A. Scotland |

The spread between 10-year Treasurys and 10-year Bunds is at a 20-year extreme. Mean reversion suggests that the U.S.–German sovereign yield spread should narrow in the coming months. The question is how? Will Europe reflate and Bund yields rise? Or will the U.S. deflate and Treasury yields fall? The initial response to last week’s quantitative easing (QE) plans from the European Central Bank (ECB) suggests the latter force will be more dominant than the former.

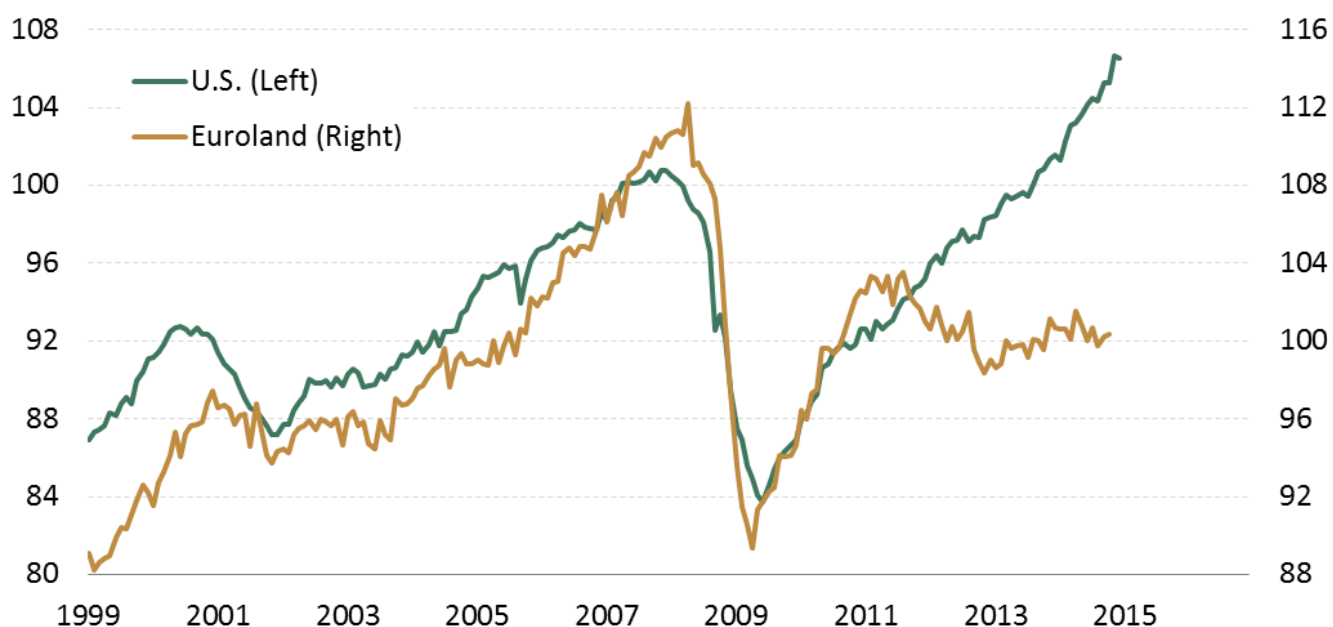
U.S. 10-Year Treasury Minus German 10-Year Bond *BPs; As of 1/26/2015*



Source: Thompson Reuters

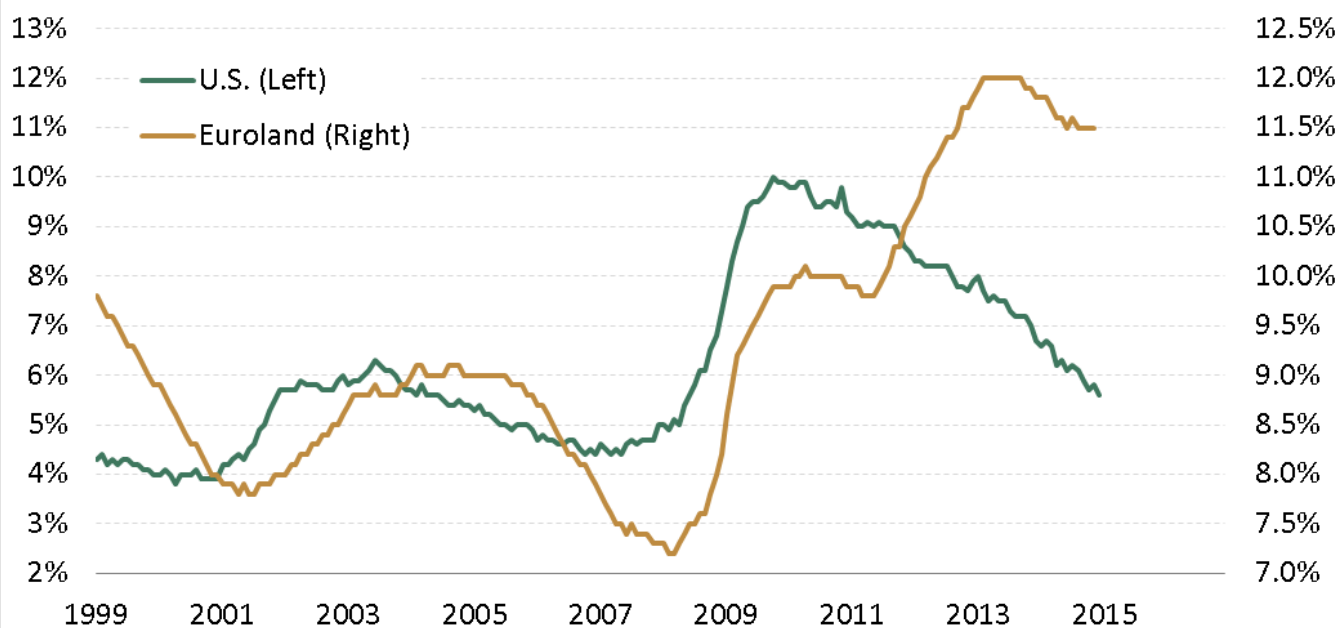
In 2011 former ECB President Jean Claude Trichet raised rates. In hindsight, this action helped trigger the European financial crisis, almost blew apart the monetary union, and set the economic region on a path to its current state of deflationary stagnation. The contrast with the U.S. economic profile since that time could not be more striking. American output and incomes have trended higher and the unemployment rate is lower; the euro zone’s output levels are lower than in 2011 and the unemployment rate much higher. U.S. five-year inflation swaps never fell much below 2% until recently; German inflation swaps peaked at 2% in late 2011 and have since sunk to below Japanese inflation expectations at roughly 75 basis points (bps).

Industrial Production *As of 12/31/2014*



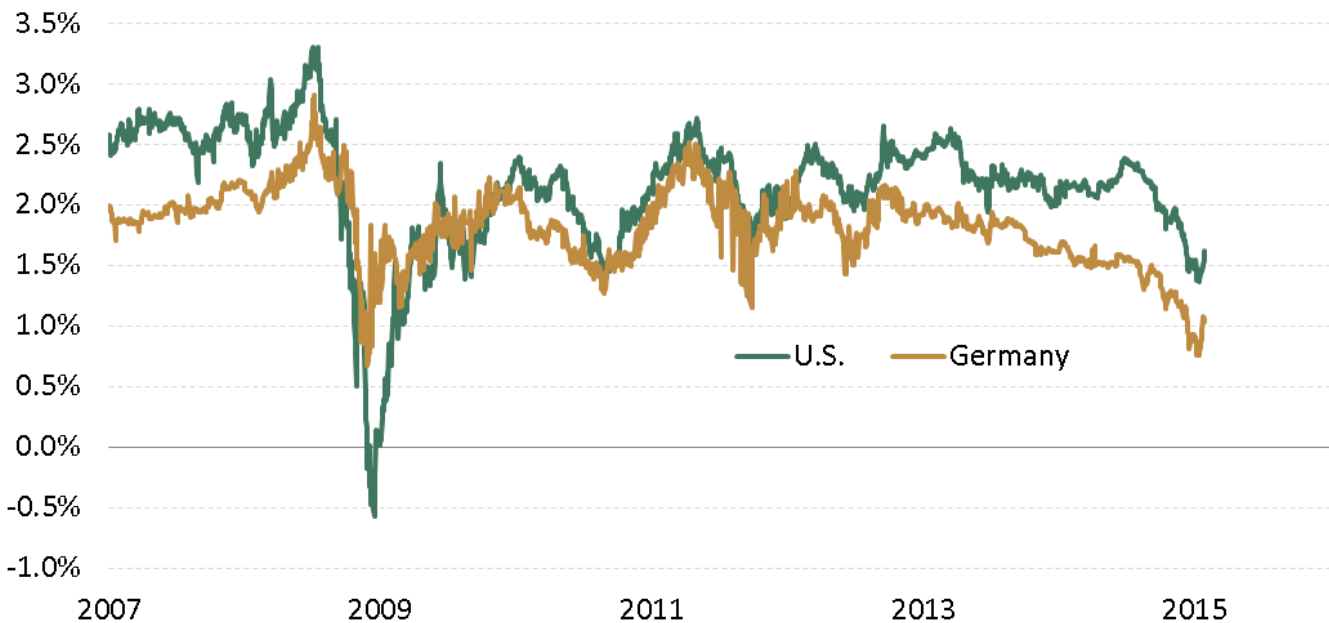
Source: Thompson Reuters Datastream

Unemployment Rate *As of 12/31/2014*



Source: Thompson Reuters Datastream

U.S. and Germany 5-Year Inflation Swap As of 1/27/2015



Source: Bloomberg

The divergence in financial market performance is equally noteworthy. The S&P 500 is up almost 60% since the beginning of 2011 and the dollar is in a bull market. The Euro Stoxx index, on the other hand, is up about 20% in local currency terms. Measured in dollars the European index has not advanced since the beginning of 2011.

Trichet made the mistake of confusing low interest rates with easy monetary policy. Draconian fiscal austerity in the peripheral troublemakers also helps explain the underperformance. But the American economy endured sequestration as well as the reversal of the Bush era tax cuts. So a large part of the explanation for Europe's malaise sits with the ECB.

Last week ECB President Mario Draghi tried to correct the wrong. After months of dithering—presumably spent coaxing Europe's Teutonic elites into acceptance—he finally launched a European version of QE. Local equities initially rallied and the euro initially fell, much like the American experience when the Federal Reserve (Fed) launched QE. Bond markets, however, reacted very differently. U.S. yields increased at the outset of every Fed QE program. Last week, Bund yields fell. Financial stocks in the U.S. jumped like a scalded cat in 2009; European bank stocks continue to weaken. Lastly, breakeven inflation rates in Germany, which have risen since mid-January, have started to pull back. These market movements suggest that the impact of Europe's latest monetary policy initiative will be different than America's experience.

The Fed's first QE launch came in 2008/2009 when financial stress was high, banks were not lending to each other, markets were not functioning, the dollar was soaring, credit spreads were wide, and the demand for liquidity soared on the back of the collapsing 40-year debt super-cycle.

In contrast:

- No such drama exists in Europe at present. The financial system is dominated by banks and is flush with cash. Inter-bank and swap spreads are low.
- Peripheral yields are already at multi-century lows in Europe, courtesy of Mr. Draghi's 2012 commitment to "do what it takes"—so, no new positive financial impulse here.
- The U.S. move to suspend mark-to-market rules during 2009 helped by reducing pressure to liquidate assets and boost capital provisions. Europe has gone in the other direction, through a brutal period of asset liquidation and equity capital raising, and it may not be over.
- U.S. QE effectively replaced banks' holdings of Treasuries with excess reserves. European banks don't

want to sell their holdings of sovereign bonds because deposits held at the central bank have negative rates.

- Lastly, U.S. QE in 2009 and 2010 was preceded by a 20% appreciation in the dollar's trade-weighted value, but the dollar reversed these gains after QE. By last week's ECB announcement, the euro had already fallen more than 20% since President Draghi first mentioned large-scale balance sheet expansion during the summer of 2014.

Ultimately, unorthodox monetary policy is about trying to create inflation, or at least arrest deflation, and boost nominal incomes. In theory, central banks have unlimited ability to do this. In practice, modern central banks can't do the Friedman "helicopter drop." For the most part, they can only buy bonds. So unless they start purchasing other kinds of assets, the transmission link is interest rates and currency valuation. The lower yields go, the less potent the interest rate mechanism and the more likely that policy shifts are affected through currency swings.

Historically, the dollar rallies roughly two years after the Fed begins to renormalize monetary conditions following a period of stimulus. The dollar's recent rally ahead of renormalization is a first. To us, the dollar rally says more about the disinflationary stagnation in the rest of the world than the strength of U.S. fundamentals. Dollar strength is also associated with lower future inflation. These all suggest that the Treasury-Bund spread gets resolved more on the side of Treasury yields moving lower relative to Bund yields.

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