W U T I S

Historical Wrap-Up

European Interest Rate Environment

Content

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Why the ECB will not hike interest rates in 2019

● Southern European Economies are still too damaged from the crisis to endure interest rate hikes. With Greece (20.2%), Spain (15.2%) and Italy (10.9%), some of the Euro area's most significant economies still have unemployment rates of over 10%

● The conclusion of the quantitative easing in December 2018, an unpredictable Brexit and concerns about worsening economic conditions have already put a lot of pressure on the Euro area in 2019 making interest rate hikes highly unlikely

● Current turmoil on the US stock market after the longest bull run ever shows that the end of the cycle has been reached. Consumption, growth and other leading indicators point at an overall cooldown and even at a possible downturn. By Q3 2019, interest rate hikes will be unlikely to take place

● As a result of these economic pushbacks, we expect bond yields to stay at current levels over 2019. We see the US 2y treasuries to remain at 2.5%. German bond yields still being in the negative for durations shorter than 10 years, we expect them to stay at current levels as well

The global economy has been experiencing a slowdown in the last quarter of 2018. The never-ending trade conflict between the US and China, an unpredictable Brexit and the slowing global economy make a hard time for central banks when it comes to monetary policy decisions. This research report aims to summarize and predict possible policy changes and scenarios of the U.S. Federal Reserve (Fed) and the European Central Bank (ECB).

Quantitative Easing and its Effects on the Euro area

In June 2018 Mario Draghi announced the gradual ending of the quantitative easing programme by the end of 2018. In December, the ECB confirmed that quantitative easing will, in fact, end in 2018 and gave no further hints regarding a possible rate hike. Keeping in mind recent events and upcoming hazards in 2019 – such as Brexit, Italy's budget dispute, further gains of anti-EU parties and economic pushbacks resulting from trade war and a decelerating US bull market – we forecast no interest rates hike in 2019

To better understand the ECB's policy of the past years, it is vital to get an understanding of its quantitative easing program. The ECB's quantitative easing program was first started with asset acquisitions of €60bn per month in March 2015 in order to boost the economy of the Euro area and to reach an inflation level of 2%. In the second quarter of 2016, monthly asset purchases were expanded to €80bn just to be reduced again to the previous amount of €60bn from January 2017. In January 2018 the amount was cut in half to €30bn. In October 2018 it was again halved and concluded entirely with the beginning of 2019.

As it can be seen in Figure 1, in addition to its primary purpose to push inflation to the desired 2% level, the quantitative easing had an overall stabilizing effect on the Euro area's economy. In addition to the positive effect on GDP growth, quantitative easing contributed to decreasing overall EU unemployment rate from 11.2% at the beginning of the program in March 2015 to 8.1% at its conclusion at the end of 2018. From mid-2015 until the beginning of 2016, inflation was close to 0% or even negative in some months. Only after the bond-buying program had been increased to €80bn per month in Q2 2016 inflation reached the target level gain. Currently, the Euro area inflation is approximately 1.6%, being revised from the original 1.9% this January.

"As it can be seen in Figure 1, in addition to its primary purpose to push inflation to the desired 2% level, the quantitative easing had an overall stabilizing effect on the Euro area's economy"

With quantitative easing being wound up, a negative effect on the Euro area's economy can be expected throughout the year and even beyond. If GDP growth does not recover from the termination of quantitative easing and a number of external events that are currently on the horizon – mainly Brexit, Italy's budget dispute, further rise of anti-EU parties and trade war – the ECB will not be able to raise interest rates without causing a recession and pushing inflation toward 0% again.

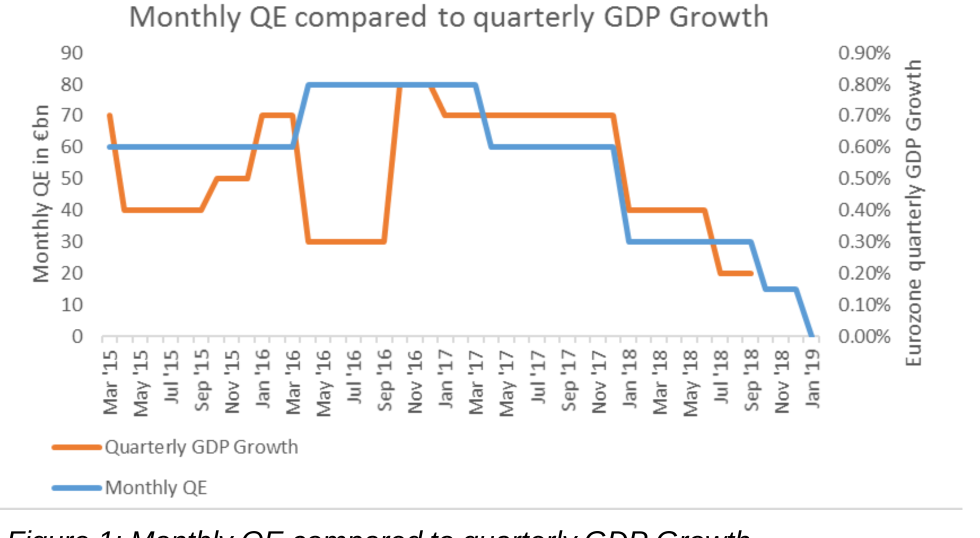


Figure 1: Monthly QE compared to quarterly GDP Growth

QE in the US and key differences between the Fed and ECB

In order to fully understand the key differences between the two major central banks, we need to take a closer look at the specific assets that have been acquired during the QE programmes. From the total assets purchased by the ECB, first, €2,076 billion were bonds acquired under the ECB's public sector purchase programme (PSPP) (euro-denominated marketable debt instruments issued by regional and local governments located in the euro area); second, holdings under the asset-backed securities purchase programme (ABSPP) reached €27 billion; third, assets bought under the third covered bond purchase programme (CBPP3) amounted to €259 billion; finally, starting in June 2016, the ECB also added a corporate sector purchase programme (CSPP), which now stands at €170 billion. (corporate bonds of the euro area) Overall, at the end of QE 2.5Tn EUR was added to the ECB's balance sheet and has ballooned to about 4.65 trillion euros. Thus, in December 2018, government bonds and recognized agencies made up around 90% of the total Eurosystem portfolio.

On the other hand, the Fed had overall three rounds in its QE program. The FED purchased a total of $1.25 trillion in mortgage bonds starting from the end of 2008, $200 billion of debt (issued by government-sponsored mortgage companies Fannie Mae and Freddie Mac), and $300 billion of long-term Treasury securities; then, in the second round another $600 billion of long-term Treasury securities starting from the end of 2011; finally, $40 billion per month of mortgage bonds had been acquired until the economy recovered and in December 2012 expanded that with $45 billion per month of Treasury bonds. (09.2012 – 10.2014) Overall when the QE ended in October 2014, the Fed had added another $1.7 trillion to its portfolio worth of a total of $4.5 trillion.

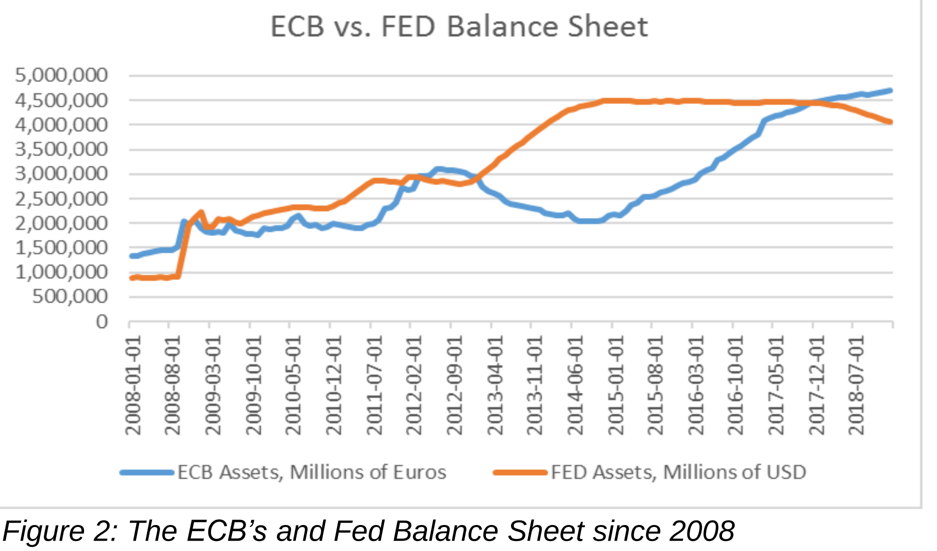


Figure 2: The ECB's and Fed Balance Sheet since 2008

The effect of quantitative easing in the US was largely the same as in the Euro area. When the program was started in November 2008, the US's GDP was in a decline, unemployment rates were on the rise and interest rates were already near 0%. As a result of quantitative easing, GDP has steadily increased 2% p.a. on average since 2008, unemployment declined rapidly, and inflation remained low and stabilized at an ideal 2% (apart from a few outliers). The S&P 500 gained more than 110% between the start of quantitative easing and at the end of 2015.

"…the FED is far ahead of the ECB in normalizing its monetary policy. This should come as no surprise since while the Fed acted immediately in 2008, the ECB only announced the launch of the bond-buying purchases programmes on 4 September 2014…"

Since the FED has already started paring back its multitrillion-dollar balance sheet in late 2017 and started steadily boosting interest rates from 0.5% in December 2016 to 2.5% in December 2018, the FED is far ahead of the ECB in normalizing its monetary policy. This should come as no surprise since while the Fed acted immediately in 2008, the ECB only announced the launch of the bond-buying purchases programmes on 4 September 2014, as a response to the declining Eurozone inflation rate.

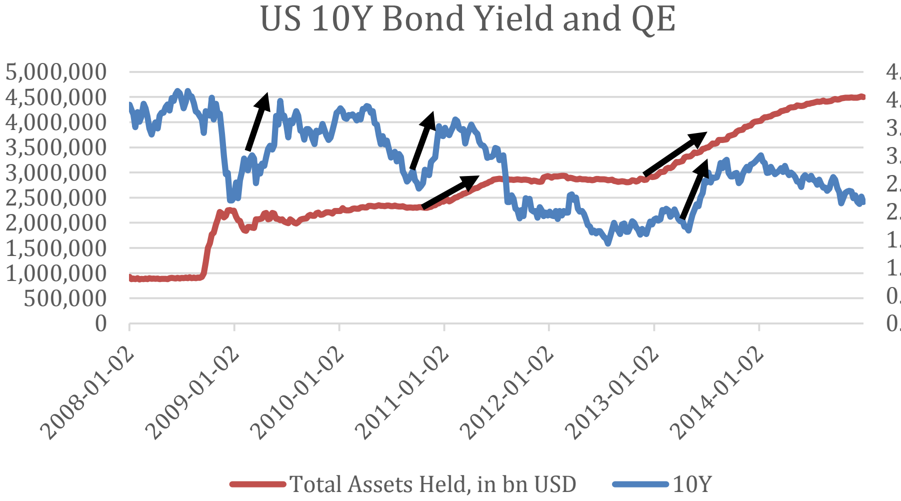
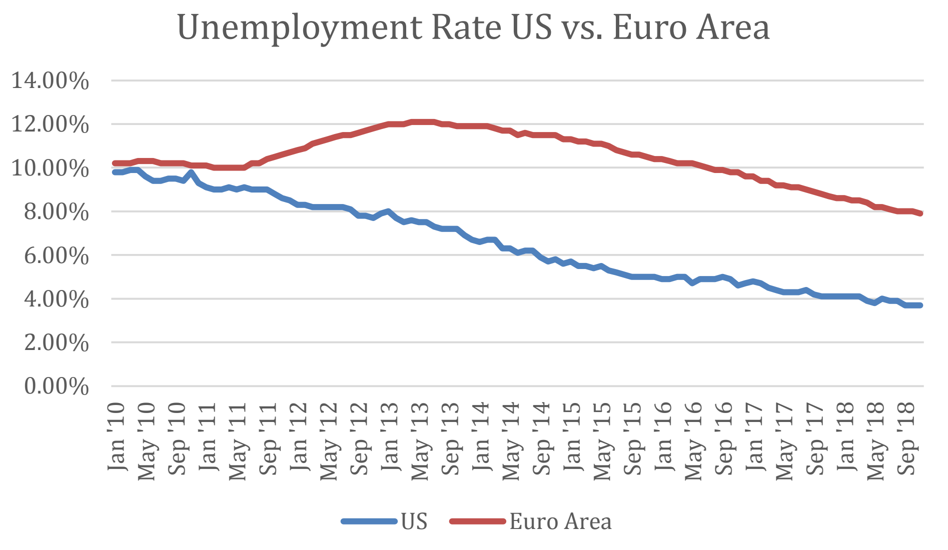


Figure 3: 10Y US Treasuries and the 3 phases of QE

Whilst most of the Euro area countries have stabilized their economy since the Euro crisis, the likes of Italy and Spain still pose a significant risk for instability due to their high government debt – Italy at 131,8% and Spain at 98,3% – and the unemployment rate of over 10%. A new crisis could pose a severe threat to these highly indebted countries. Therefore, it is a key task for the ECB to determine an interest rate that works for the entire Euro area. This is a key difference to the FED, which regulates a much more homogenous economy than the ECB. Additionally, the fact that the US has one federal fiscal policy, while in the Euro area every country has its own fiscal policy makes it much easier for the FED to find the right monetary policy.



The Euro Area's Problems and an Economic Outlook

In addition to the troubled Southern economies, there are some other factors that will influence the ECB's decision. The looming Brexit with its worst-case scenario of a "hard Brexit" is still possible in March 2019 and would certainly mean a lot of trouble for the Euro area. Additionally, Italy with its continuing budget dispute has proven to be a source of uncertainty for investors. After news of Italy's controversial budget proposal became public, equity and bond markets immediately punished the Italian government. This marks a slap on the wrist, since the highly-indebted country does not want to suffer even higher interest payments for its debt. Rome agreed to delay some spending measures, compromising on a 2019's budget deficit of 2.04% compared to the 2.4% initially envisioned. However, the agreement fails to tame concerns about the health of the country's banks and financial health.

"…the spread between 3-year and 5-year treasuries even reached a negative level on December 3."

Furthermore, economic indicators lead us to believe that the economic and debt cycle is reaching its end. Since the financial crisis, equity markets have seen the longest bull market ever. However, with volatility being back, a lot of factors indicate that this period is now over and that a peak has been reached in 2018. As can be seen in *Figure 3*, the yield curve spread is getting dangerously near 0%. A negative spread between T-Bills and 10-year US bonds often indicates a downturn in the coming quarters. While this did not happen, the spread between 2-year bonds and 10-year bonds have reached its lowest point since 2007 and the spread between 3-year and 5-year treasuries even reached a negative level on December 3.

Finally, even though investments in bonds won't be accelerated, the capital which is collected from maturing bonds can be reinvested. This gives the European policymakers the possibility to adapt to their environment and changing conditions. Reinvesting this money should prevent the fast shrinking of the existing stimulus efforts of the ECB. Experts do not expect the ECB to react as quickly as the FED if the slowdown worsens. Mario Draghi pointed out there is no reason for pessimism, since the wages and job creations are rising.

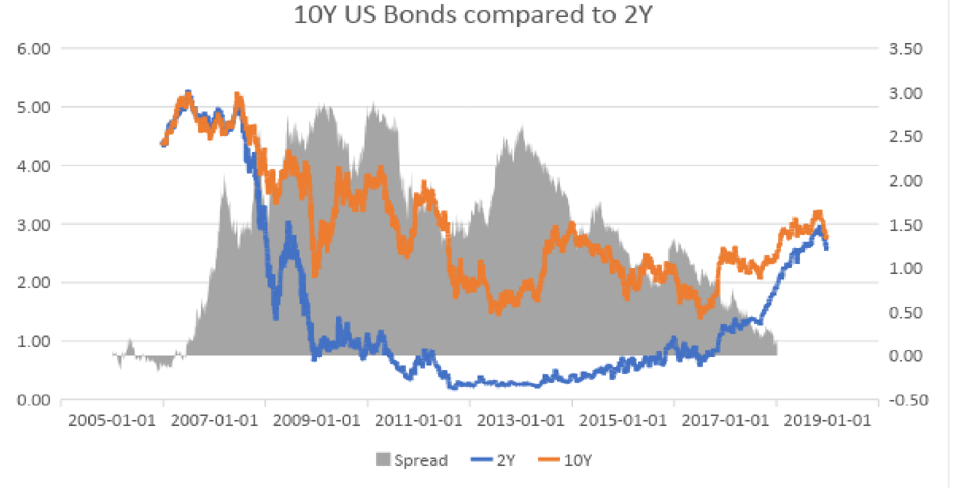


Figure 5: 10Y US and 2Y US spread

"Powell's plan to move on with gradually hiking, certainly changed and sounds more promising than Draghi's reference to the leftover QE reinvestment, forward guidance, APP and TLTRO as an answer for a possible recession."

Conclusion, alias why the ECB will not hike interest rates

To sum up, after consciously dialling back on his previous statements, Powell highlighted that the FED could afford to be patient regarding future policy decisions as the stock market stayed volatile, economic growth weakened and inflation concerns remained muted. Powell's statement in late 2018, where he saw rate hikes to be far from neutral and planned to move on with gradually hiking, certainly changed and sounds more promising than Draghi's reference to the leftover QE reinvestment, forward guidance, APP and TLTRO as an answer for a possible recession. As we expected headline inflation to decline further and a rise in employment and wages did not convert into underlying price pressures, measures of underlying inflation remain generally muted but are expected to increase over the medium term.

Taking the Euro area's weak GDP growth, as well as its weakest members' government debt and unemployment rate into account, rate hikes would simply be too risky and could tip the current growth of 0.4% into a recession. Although the likes of Germany, the BeNeLux countries

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and the Nordic countries would probably have no problem digesting interest rate hikes, Southern Europe will not be ready to do so by the end of 2019. The number of risks and potential setbacks in 2019 are far too high to expose the Euro area's weakest links to such precarious dangers and therefore, we expect to see Mario Draghi's term expire without raising rates as president.

Finally, the US economy – which has traditionally been a draft horse for Europe's economy – shows signs that the longest ever bull run as well and thus the economic cycle could be over. Volatility is as high as it has not been since the last crisis, economic indicators hint at a possible downturn, the US equity market lost its entire 2018 gains within a few weeks, and economists claim that the time of ever-rising equities are over despite a surprisingly good start this year which, in our opinion, was primarily fueled by hope rather than a solid global economy.

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