INVESTMENT BRIEF

Q3 2014

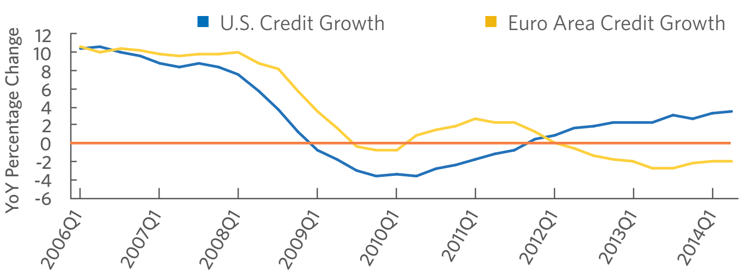
Strategic Investment Group®

Don't Fight the ECB

Investors today face disparate economic conditions in the major regions of the world, especially in the stark contrast between the recoveries in the U.S. and Eurozone. The U.S. recovery, on the one hand, is well advanced. Growth is above trend, economic uncertainty is declining, capacity utilization is rising, unemployment rates are falling, and household and bank balance sheets are more robust. As a result, capital expenditure, although still low, is showing signs of picking up, and banks are lending (Exhibit 1). The combination of a solidifying recovery and easy monetary conditions has promoted a rally in U.S. equities, especially in 2013, and a compression of risk premia across all major asset classes.

Exhibit 1: Credit growth in the U.S. and Eurozone

Source: International Monetary Fund



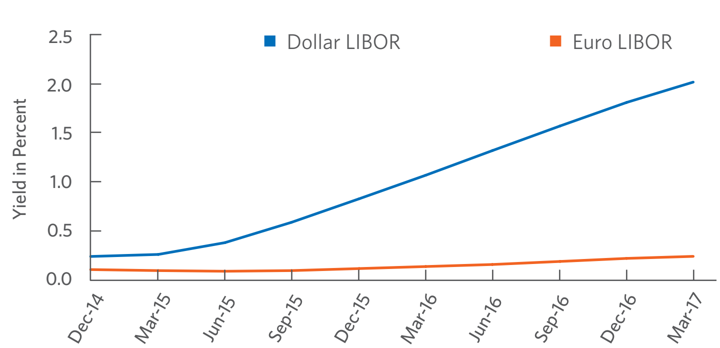
The Eurozone's recovery, in contrast, is faltering and the process of deleveraging is less well advanced. Households remain heavily indebted and bank balance sheets are still fragile. Unemployment is shockingly high, firms have excess capacity, and capital expenditure is anemic. Ultra-low inflation has made deleveraging more difficult and raised the prospect of a deflationary spiral. With households and banks constrained and capital spending low, credit in the Eurozone continues to contract (Exhibit 1). Against this backdrop, risk premia have not been compressed to the same extent as in the U.S. Eurozone equity and credit markets are anticipating continued bad news.

The Fed and ECB part ways

This tale of two recoveries has induced contrasting policy responses. The Fed has already begun to reduce its asset purchases as a prelude to raising rates. In contrast, the ECB has announced an aggressive program of balance sheet expansion to spur credit growth. Given these conflicting policies, futures markets are pricing in a widening gap between dollar and euro short-term interest rates (Exhibit 2). Longer term yields show the same divergence, with German 10-year bund yields at all-time lows in absolute terms and relative to comparable U.S. Treasury yields.

Exhibit 2: Expected path of U.S. and Eurozone 3-month LIBOR

Source: Bloomberg



Implications for Eurozone equities

We have maintained a tactical overweight to European equities. With the recent commitment of the ECB to undertake an aggressive policy of quantitative easing, we have added to that overweight position. Given the ECB's goal of euro depreciation, we have hedged this additional currency exposure. There are three main factors underpinning our decision. First, we find the current valuation of European equities to be quite attractive. The bad news of a faltering recovery and deflation risk has been fully priced in. There is potential for positive surprises. Second, aggressive quantitative easing by the ECB will be a significant support to Eurozone equities in the same way that quantitative easing by the Fed buoyed U.S. markets and encouraged the compression of risk premia. Moreover, ECB action should boost credit growth and push the euro lower. Finally, European corporate earnings are subpar but on an improving trend, and the economic impact of more supportive monetary policies should further improve the potential for earnings growth.

The widely divergent monetary policy responses to the unequal recoveries in the U.S. and Eurozone will be a key influence on global markets. More specifically, the ECB's renewed commitment to revive the faltering Eurozone economy presents us with a tactical investment opportunity to emphasize European equities, which we believe will redound to the benefit of our portfolios.

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