

# APROPOS...

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## How QE impacts currencies

In a previous *APROPOS...*<sup>1</sup>, we discussed the effects of Quantitative Easing (QE) on asset prices and came to the conclusion that prices are significantly and consistently distorted. We argued that central bank credibility is essential and imagined what could happen if it disappears. In this issue, we will discuss what to expect in case central bank credibility remains intact.

Our perspective regarding the QE debate is that central bank policies have stripped any information content from market prices. Central banks are special economic agents that do not intend to maximise profits as private sector agents do. Instead, they aim to maintain a stable financial system. To achieve this goal, they sometimes act in the same way as pain killers. Taking pain killers does not solve the very reason for the pain, but only distorts the signal, which has been sent to our brain. As a consequence, you do not *feel* the pain any more, even though you are well aware that it is still there. In other words: you are voluntarily fooled. With QE, the mechanism at work is very similar; central banks distort price signals – the information content – and even though investors are well aware that what they see is actually not real, investors are consistently and repeatedly fooled. From this point of view, QE is an effective medicine.

As credibility of central banks has been undisputed so far, interest rates and yields all around the world have converged to virtually zero and have moved in parallel. For a fixed-income investor whose reference currency is the single currency, there is no difference between investing in government bonds from Germany, the US, the UK, Japan or Switzerland, if currency hedge costs are taken into account as illustrated in graph 1. Basically, the return of any of these investments has become identical and zero<sup>2</sup>. In a *zero economy*, that is – by giving full scope to one's imagination – an economy in which all key variables correspond to zero (growth, inflation and productivity), such an outcome is not surprising but rather consistent.

As long as you are seated comfortably on your couch, there is no inconsistency between having a broken leg and not feeling any pain (when the pain killer is strong enough). But if you decide to get a drink from the fridge that may

only be one step away from your sofa, the pain killer, as powerful as it may be, will not help you walk. Then, suddenly a clear inconsistency appears, i.e. a strong cognitive dissonance between pain killer-implied complacency and the reality of the broken leg. In economics, it is very similar: as long as all economies are hovering around zero, there is no obvious inconsistency that all yields are at zero. However, not all economies are taking pain killers for the same reason, because they are fundamentally different and there is no reason to believe that they will all follow the same path.



Source: Bloomberg, ETHENEA

Graph 1: One year expected return in euro of a 10-year government investment with currency risk hedged

However, the longer the QE programme lasts, the longer the fundamental differences are masked by homogeneity in yield curves. At some point, differences in fundamentals will resurface and both economies and financial prices will have to adjust in order to reconcile imbalances. How can these adjustments take place in a world of credible and thus powerful central banks?

First, the idea of a credible central bank implies that the yield curve is controlled and second, that consumer prices can be set to be neither inflationary nor deflationary. In this environment, differences between economies such as diverging productivity, inflation and government riskiness cannot be priced in the yield curve nor reflected in inflation; these divergences have to be expressed differently.

The exchange rate has become the adjustment variable of choice, as the term *currency war* reminds us. Since the generalisation of zero or negative interest rates and Quantitative Easing policies, the behaviour of major

<sup>1</sup> See *APROPOS...* from August 2016: [How QE distorts prices](#).

<sup>2</sup> Between 2006 and 2008 for example, the situation was dramatically different. In EUR terms, an investment in German government bonds (about 4%) yielded twice as much as a similar investment in Japanese bonds (about 2%), whereas nowadays its yields correspond to zero (Graph 1). Notice that in our example, currency risk is hedged for twelve months.

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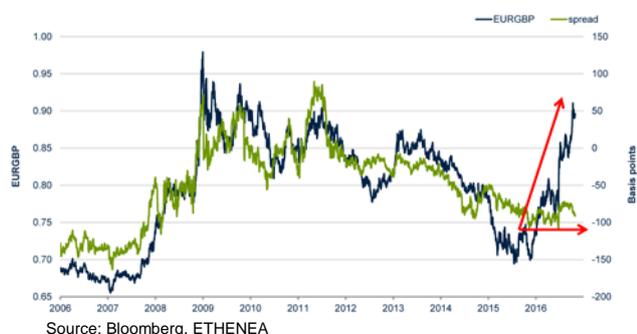
currencies such as the euro (EUR), the US dollar (USD), the British pound (GBP), the Swiss franc (CHF) and the Japanese yen (JPY) has changed. Currencies have become what is known in economic jargon as *jump variables*, variables that jump from one state to another in order to rebalance fundamental divergences.

One way to illustrate this change in behaviour is to compare exchange rates with yield changes. It is a well-established fact that currencies appreciate when interest rates rise and depreciate when rates decline. The strategy of borrowing in low-yielding currencies and investing the proceeds in high-yielding currencies is known as *carry trade*, an investment strategy that was fashionable before the global financial crisis.

In graphs 2, 3, 4 and 5, the major EUR currency pairs are represented with their respective 2-year maturity yield spread. For example, graph 2 presents the EURUSD exchange rate and the 2-year government yield differential, currently in favour of the US dollar (approx. 150 basis points). Based on this single metric, a EURUSD exchange rate at about 1.20 would seem more reasonable.



Graph 2: EURUSD and 2-year yield spreads



Graph 3: EURGBP and 2-year yield spreads



Graph 4: EURCHF and 2-year yield spreads



Graph 5: EURJPY and 2-year yield spreads

The red arrows show that at some points in the last few years, spreads and currencies have diverged. Currencies jumped suddenly and massively from one level to another within a very short period of time, in a way that is not explained by movements in yield spreads. In addition, this phenomenon has been observed only recently. There were no such jumps in the dark days of the global financial crisis, not even when financial markets were dislocated, confirming thus that the generalisation of QE policies worldwide is a cause of currency instability.

We strongly believe that currency movements will continue to jump in the future as long as central banks maintain, credibly and powerfully, their policies of low interest rates all over the yield curve and across the world. One of the consequences of this policy is that it has erased any information content from market prices. Central bank policies mask the countries' fundamental heterogeneities under a veil of stability: zero inflation, zero interest rates and zero yields. The currency market however is the least controlled financial market and is thus the place where, ultimately, rebalancing takes place.

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