

SUPER MARIO SUPPORTS EURO HEDGED EQUITIES

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It looks like 2014 is shaping up to be the year of euro-hedged European equities. This is, in part, thanks to European Central Bank (ECB) president Mario Draghi. His recent comments discussing a strengthening euro as a key contributor to [disinflation](#)— or declining levels of inflation—suggest that he’s committed to preventing the euro from further appreciation. In many ways, he’s already been successful, as the euro has trended down from \$1.39 to \$1.36 on June 5, the day of his latest policy measure announcements.¹ But Draghi has taken a step beyond rhetoric and is taking measures designed to support inflation and the European economy in a number of targeted ways. He detailed the unanimous decision of the ECB’s Governing Council to provide a package of [monetary easing](#) programs designed to confront low levels of inflation. **Key elements include:** 1) Cutting three key interest rates while extending the ECB’s [forward interest rate guidance](#) (or the outlook for keeping low interest rates for a longer period) including a cut in the ECB’s [deposit rate](#) that puts it in negative territory. Effectively, this means banks will have to pay to keep money on deposit at the ECB—which may encourage more lending. 2) The announcement of €400 billion in targeted long-term financing for banks to support lending to corporations, which is intended to counterbalance the [de-leveraging](#) that banks are engaging in so that they can pass [stress tests](#) on their loan portfolios. 3) Suspension of the liquidity [sterilization](#) of the Securities Markets Program, which, in simple terms may lead to an expansion of the ECB balance sheet, and which is generally thought to support a weaker euro. One critical transmission mechanism of these policies, bank lending to many small and medium-size enterprises, has been constrained, especially in the peripheral European markets. A key part of this new financing package is that the ECB’s extension of loans does not support housing markets or the sovereign debt markets—which Draghi alluded to as having “bubbly” characteristics.² Draghi’s targeted long-term funding operations—which come at a fixed, low rate of interest—should support net new lending to corporations. This package is intended to lower the cost of funds for European businesses; more generally, it is intended to support the budding economic recovery for businesses. Another area Draghi is avoiding is lending for mortgage purchases, which is a sign that he is distinguishing himself from programs in the United Kingdom that many think are leading to very high home prices.³

Implications for Equity Investors When asked about future measures, Draghi said, “We aren’t finished here.” This implies that there is more to come, and it echoes his statement in June 2012 that the ECB would do “whatever it takes” to save the euro during the crisis—a statement that was a key to the rebound in sentiment for the euro in late 2012 and 2013. Giving a sense of its short-term expansion plans, the ECB announced plans to “intensify preparatory work related to outright purchases in the ABS [asset-backed securities] market to enhance the functioning of the monetary policy transmission mechanism.” These additional monetary policy measures to counter the potentially [deflationary](#) trends caused by the euro’s strength lead to a natural question: What about the large flow of assets to European equities banking on a growth recovery? The vast majority of the investment products in the United States targeting exposure to Europe should consider two sources of [risk](#): **1) Equity Market Risk:** Exposure to movements in local European equity market prices **2) Currency Risk:** Exposure to the movements of the euro and other European currencies, such as the Swiss franc and the British pound, against the U.S. dollar I reiterate: Why take the additional currency risk when the head of the ECB is telegraphing very plainly that he does not want to see the euro appreciate much further? There appear to me to be real downside risks but no real upside potential for some time. The ECB monetary easing that was announced—plus further additional enhancements, should they be warranted by a lack of inflation—could be beneficial to growth in the economy, helping companies’ profits. But these programs potentially render the currency exposure a source of unrewarded [volatility](#). Therefore, one should very strongly consider euro-hedging European equities. Draghi has taken what we believe to be a positive step for the Eurozone, but again, why would one want to assume euro risk when seeking exposure in this region? We believe that this announcement could make it particularly interesting to consider currency-hedged equities.

¹Source: Bloomberg; \$1.39 refers to the euro-to-U.S.-dollar exchange rate on May 6, 2014, whereas

\$1.36 refers to the euro-to-U.S.-dollar exchange rate on June 5, 2014. ²Source: European Central Bank, June 5, 2014, press conference. ³Source: European Central Bank, June 5, 2014, press conference.

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DEFINITIONS

Disinflation : Term used to describe instances of slowing inflation, different from deflation in that price levels are still increasing overall, just at a slower rate.

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

Forward guidance : A central bank policy tool intended to guide market expectations regarding the future of policy rates.

Deposit Rate : The rate parties receive for deposits at the central bank.

Deleverage : Bring down levels of debt.

Stress tests : Standards applied, most typically to banks, meant to gauge how well these firms might be able to weather adverse market event.

Sterilization : Activity undertaken by a central bank meant to mitigate the impact of other policies on changing the overall supply of money in an econom.

Deflation : The opposite of inflation, characterized by falling price levels.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Volatility : A measure of the dispersion of actual returns around a particular average level. nbsp;.