

# Fed signalling rate hike vs ECB accelerating QE: policy divergence may warrant hedging euro uncertainty

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A resilient US economy, underscored by a hawkish sounding Fed amidst a tightening labour market is preparing investors for a very likely first rate hike since 2004. By lagging several years behind the US recovery, the QE-induced low interest rate environment should remain Eurozone's crucial support driver for at least until 2016. The diverging policies between the Fed and ECB may widen the interest rate gap between the US and Eurozone. This being fundamentally dollar supportive while undermining the euro, it potentially adds to more euro volatility and depreciation risk. WisdomTree Europe Equity UCITS ETF - USD Hedged (HEDJ) offers investors exposure to a basket of export tilted Eurozone stocks that hedges the euro-dollar exchange rate risk.

## **US Fed looks beyond commodity slump and seasonality to justify potential tightening**

Last month's meagre GDP growth in Q1 for the US economy was broad-based, attributed to a slowdown in consumer spending, downturns in private investments, exports and state and local government spending. Only increased inventory build-up and federal government spending has worked to offset the weaknesses. And yet despite of this Fed Chairman Janet Yellen gave the clearest signal yet to end the six-and-a-half-year stretch of near-zero interest rates as it looks to hike the Federal funds target rate sometime later this year. As the world's largest economy is expected to accelerate, there could be no better signal for investors to stay invested in risk assets, most notably in European equity markets that have a strong export exposure and hence cyclical bias to US.

The outlook for US economic activity this year is likely to improve and driven in part by two factors that have slowed down, if not distorted US economic growth this year: the sharp fall in crude oil prices last year negatively impacting the energy sector's production and investment activity (particularly with respect to shale oil producers) and the harsh winter delaying consumer spending. Both have contributed to the US entering a state of temporary disinflation and weaker domestic demand. However, the stable if not somewhat higher outlook on crude oil prices for 2015 has created a much brighter inflation picture. Because, aside from the stabilizing oil prices' dissipating base effect of year-on year changes to CPI readings, the years of persistent gains in the jobs market have started to feed through into tighter labour market conditions as the pressure on employers to raise (minimum) wages this year has steadily been building up. This, combined with the summer season that is expected to reverse the weakness in private spending in Q1 as a result of the harsh winter should provide for much stronger demand driven US growth over the summer.

## **ECB's QE-induced yield suppression works to contain the euro**

With tighter monetary conditions in the US raising inflation expectations and along with it, real and nominal US interest rates, the euro is likely to remain subject to increased volatility. This because with the ECB firmly in exceptional monetary easing mode, the interest rates in the Eurozone will remain actively suppressed. The potency of the ECB controlling sentiment in Europe's credit markets this way should not be underestimated, as has been demonstrated this month when it announced to accelerate its QE program in anticipation of weaker bond market liquidity conditions in July and August. This has happened to coincide with a sharp sell-off in Eurozone bond markets amidst growing unease over the record low bond yields of German Bunds (with the 10 year issue yielding less than 20 bps at the end of April). Following the ECB's announcement, tensions have since dissipated and at around 60 bps, the yields on 10 year German Bunds remain anything but appealing, let alone normal. When considering a robust growing German economy to likely post inflation rates well above 1 percent as recovering oil prices feed through, the long dated German bond yields should in fact be potentially much higher in the absence of QE and more closely aligned to the bond yields of US Treasuries. But until QE is wound down at the earlier in 2016, the artificially low interest rate environment is likely to prevail, not least because falling Eurozone bank lending rates leave little room for higher deposit rates, and the risk of contagion.

The contrasting monetary policies between the Fed and the ECB show the extent to which the Eurozone lags behind the US recovery and economic expansion: The ECB announced its QE program in January 2015, more than two years after the Fed announced its QE3 program in 2012 (\$40 billion of agency mortgage-backed securities per month in September, \$45 billion of US Treasuries per month in December). The result is that the interest rate spread between the US and the Eurozone is expected to remain large for a considerable period, and may even grow wider as upward pressure on interest rates in the US is building up. On chart 1 the long dated bond yield differential between US Treasuries and German Bunds is about 150 bps, a significant yield gap that favours US assets over German (and most if not all Eurozone) assets. This lack of relative fundamental support is likely to be one of the main drivers of a volatile path for the euro-dollar exchange rate and its potential to depreciate further.

The irony is that a weak euro managed by the ECB's QE policy is helping the bullish sentiment in Eurozone equities to sustain itself. Hence, foreign investors incurring the exchange rate risk may want to consider a currency hedged exposure to Europe's equity market so as to isolate the potential downside currency returns from the potential upside equity returns. By focussing on stocks with significant export exposure, the WisdomTree Europe Equity UCITS ETF - USD Hedged offers investor an investment that is sensitive to the euro-dollar exchange rate. Faced with divergent monetary policies between the Fed and the ECB that may last several years, the ETF may offer investors an efficient bearish euro-dollar, bullish Eurozone equities allocation. Investors sharing this sentiment may consider the following UCITS ETF:

- [WisdomTree Europe Equity UCITS ETF – USD Hedged \(HEDJ\)](#)

*All data is sourced from WisdomTree Europe and Bloomberg, unless otherwise stated.*

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