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Implications of European Central Bank Rate Hike in April

Executive Summary

- **On Mar. 3 2011, the European Central Bank announced an interest rate hike in April is possible.**
- **The move will further strain the finances of peripheral members in the Eurozone and worsen the medium to long term economic outlook of the region.**
- **The banking sector is likely to face tighter liquidity conditions as access to cheap funding dries up. Banks in Ireland, Portuguese and Greece are at risk.**
- **Speculators are getting one-sided in their bets on an appreciating Euro dollar. A strong Euro dollar is likely to hit European exporters and slow the region's manufacturing growth.**

Introduction – From Global Recession to Global Inflation

For the first time in more than 23 months, the record low 1 percent benchmark rate set by the European Central Bank (ECB) may be coming to an end. On Mar. 3 2011, ECB President Jean-Claude Trichet said that the ECB may raise interest rates next month for the first time in almost three years to fight mounting inflation pressures. Accordingly, an "increase of interest rates in the next meeting is possible," Trichet told reporters in Frankfurt. "Strong vigilance is warranted," he added in reference to containing upside risks to price stability.

The recent shift in the ECB's policy bias caught the market by surprise. In particular, the Euro currency appreciated from 1.384 to 1.397 against the US Dollar within minutes of the announcement. To those whose memory are fresh, the troubled euro single currency was trading at 1.186 against the US Dollar six months ago when Greece went on a bailout. The Euribor interest rate futures implied that the ECB may raise the benchmark rate to 2 percent by year end. We feel that there could be three impacts to European capital markets if the rate hike comes in April. Firstly, the economic conditions among the peripheral nations will worsen. Secondly, the banks in Europe will have to withstand tight liquidity conditions and struggle to assess funding. Lastly, the level of bullishness in the euro currency may spark a concern for the European exporters, even if the rate hike does not materialize.

Latest Developments – Economic Recovery and Inflation

In December 2010, the ECB predicted inflation will average 1.8 percent this year and 1.5 percent in 2012. The inflation rate jumped to 2.4 percent in January, the highest in more than two years. According to Bloomberg, the ECB is concerned about so-called second-round effects, when companies raise prices and workers demand more pay to compensate for soaring energy and food costs, contributing to further inflation.

Over the near term, inflation looks to be on the rise in Europe and perhaps globally. The United Nations announced that world food prices rose to a record level in February and may exceed this level over the next few months. The unrest in the Middle East is not easing price pressures as the pressure on oil prices increases.



Negative Impact on the Peripheral Nations

An ECB interest rate hike will be especially painful to the economies of the European peripheral members. So far, the debt crisis has been concentrated among the five peripheral nations and these borrowers are likely to be hit by high interest payments in due time as a result of the increase in their government bond yields. The peripheral nations will have problems raising billions of funds at an unsustainable high cost in order to fund their public finances in the coming quarters. Recently, investors have been driving up Portugal's borrowing costs. The nation's 10-year bond yield traded above 7 percent since Feb. 4, a jump from the 4 percent level back in March 2010.

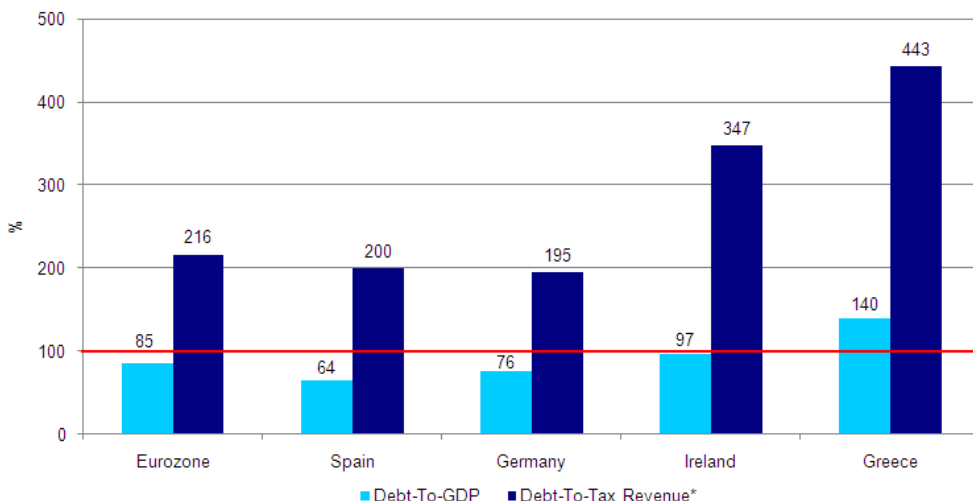
On the other hand, an overall rise in interest rate will result in the European banks tightening their lending criteria. The tight monetary conditions are already impacting the near term growth outlook of various private sectors. On the household level, Reuters reported that almost 9 out of 10 mortgages are tied to the 12-month Euribor rate in Spain itself. The last thing the Spanish (or even other European) households hope for will be an increasing mortgage burden.

Broadly speaking, an ECB working paper dating back to 2001 estimated an interest rate increase of 100 basis points sustained over a two-year time period will leave GDP in the broader Eurozone one percentage point lower than its "steady state" value after three years. It describes the negative impact on GDP as "lagged and gradual", citing the depressing effect of higher rates on investment and competitiveness, based on an initial appreciation in the nominal exchange rate (which will be discussed in next section).

Until we see a more practical European-level policy response, structural reforms, proper fiscal austerity and discipline at the national level, the overall economic condition could turn for the worse over the medium term. Longer term, there may be really little to cheer about given that a potential ECB rate hike may do more harm than good, especially to the five peripheral nations.

Chart 1: Borrowing is Solution, Debt is Problem

Debt-To-GDP % & Debt-To-Tax Revenue %



*incl. social insurance contributions - w/o employer contribution

Over-investment and a rapid rise in private sector through foreign indebtedness landed the countries in huge debts.

Source: European Commission, as of end 2010



A Shock to the European Banking System

The overall European banking system will be adversely affected as well. We feel that banks in Ireland, Greece, Portugal and even Spain are poorly capitalized at the moment to withstand a rise in borrowing costs.

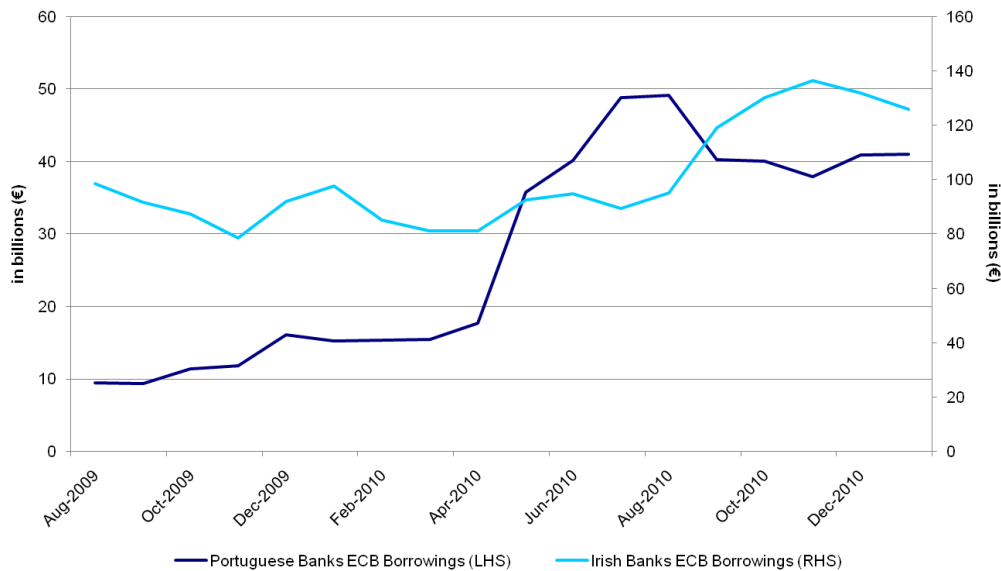
Banks in Portugal, Greece and Ireland will be hit especially hard on the back of a further rise in borrowing costs. These banks have grown dependent on the ECB for liquidity after losing access to interbank funding. The low borrowing costs provided by the ECB was one of the main factors that the overall debt crisis being kept in check at the moment. We feel that many peripheral nation's banks are poorly capitalized at the moment and will be hit hard should the presence of cheap funding vanishes. In a worst case scenario, we may see further bailouts on the banks and this might well translate into a return to the ECB funding mechanism on the peripheral nations' part. We strongly believe that in the event of a second round of government bailouts on the individual banking sector, it will be much more costlier than the previous round back in November last year.

Chart 2 below will reflect how heavily reliant are the peripheral nations' banks on ECB funding. In particular, the Irish banks' reliance on ECB funding rose in January to the highest in recent years. The Irish banks' overall borrowings from the ECB rose to €126 billion as of January this year. Before the sovereign debt crisis, ECB funding to Portuguese banks totaled €15.3 billion in January 2010. One year on, it was €41.0 billion. Portugal accounted for more than 9 per cent of total ECB funding.

There will be a political commitment to shore up the European banking sector. The German landesbanks, together with the Spanish cajas are exposed in one way or another to other poorly capitalized banks. Keeping the others afloat is as good as keeping the whole banking sector alive. In short, a potential rate hike will expose the weak fundamentals of the peripheral nation's banks, bringing wide implications.

Chart 2: Heavy Reliant on Cheap ECB Funding – Irish and Portuguese Banks

Irish and Portuguese Banks Heavily Reliant on ECB Funding



Heavy reliant on cheap funding from the ECB has been keeping the Irish and Portuguese banks afloat.

Source: Bloomberg, as of 07 Mar 2011

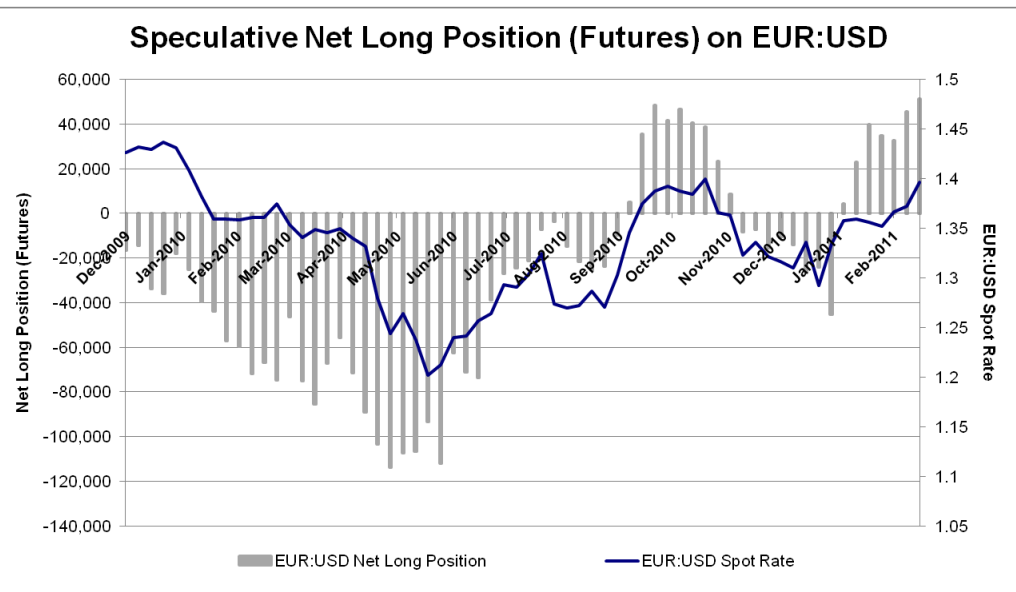


Speculator Definite Bullish on the Euro currency – For Now

Since the start of the year, we saw a bullish move in the euro currency, with the euro up 8.8 percent against the U.S. dollar. According to the latest data from the Commodity Futures Trading Commission, the number of contracts that hedge funds and other large speculators hold at the Chicago Mercantile Exchange anticipating a gain in the single currency jumped to 51,308 as of Mar. 4 (See Chart 3 below). The last time so-called net longs exceeded 45,000 contracts was in October 2010.

As reported by Bloomberg, strength in the euro relative to the U.S. dollar was a result of the Fed Reserve showing no signs of raising interest rates even though the economy is strengthening. Therefore, we feel that a rising euro could hamper the manufacturing arm of the export-driven countries with Germany and Ireland inclusive. In particular, Germany exports an estimated total of €95 billion to United States and China on a yearly basis. This amount make up nearly 8 to 9 percent of the total exports to the largest national economy in Europe. A strengthening domestic currency typically work against the exporters.

Chart 3: Speculators Taking Massive Long Positions in EUR:USD Futures



An appreciating Euro dollar is mainly driven by speculators on the long side of the futures contract.

Source: Bloomberg, as of 07 Mar 2011

Looking Ahead – Credibility of ECB to be Tested in April

Back in July 2008, the ECB surprised markets and decided to hike in circumstances where many market participants would least expected. This determination or stubbornness has underlined the credibility of the ECB’s anti-inflation credentials.

We think the ECB is likely to begin a process of normalising interest rates in the coming quarters. However, we find the present inflation problems being supply-driven and raising interest rates will do little to tame it (India will be the best example). In the near term, markets have begin to price in the prospect of ECB rate hikes through into early 2012. The prospects for Eurozone growth and the outlook for peripheral nations are likely to be compromised. For the mentioned reasons, we do not see investment opportunities in the European continent at the moment.



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