Daily Note

WHEN THE TIDE GOES OUT

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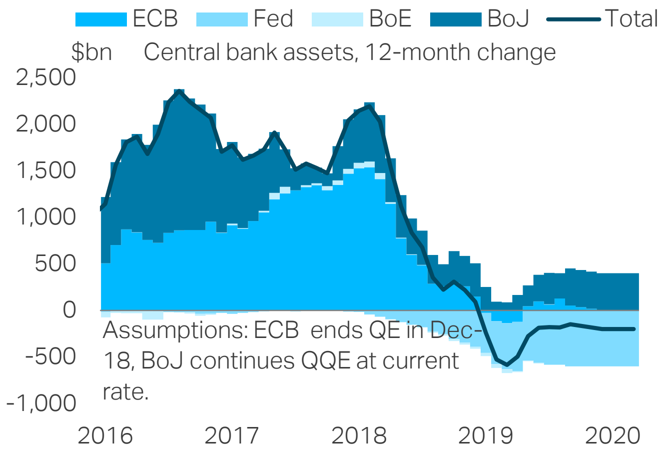
- **End of QE is a major regime change with significant consequences**
- **Rising USD demand for year-end could trigger more liquidity tightening**

High tide has passed. Since the recent high of central bank QE addition in February this year, the reduction in asset purchase pace by the BoJ and the ECB, and the increase in the Fed's pace of balance sheet normalisation, will flip the 12m sum of QE provision into net contraction by the start of next year (Chart 1).

Falling tide bringing choppier waters. The first eigenvector (that is, the first principal component) of our PCA on global fixed income returns now explains less than 50% of the market's variance (Chart 2) – the lowest since mid-2012, when the combined efforts of Draghi ("Whatever it takes") and Bernanke (pre-announcing Fed QE3 at Jackson Hole, both marked with 'x's in the chart below) started this six-year period of extraordinary central bank influence. The characteristics of the eigenvector have also changed – only a few weeks ago, it was closely related to term premium and the pace of ECB QE. Now, with Italian risks elevated, its correlation to these factors has fallen. Fixed income markets are becoming more volatile and less predictable.

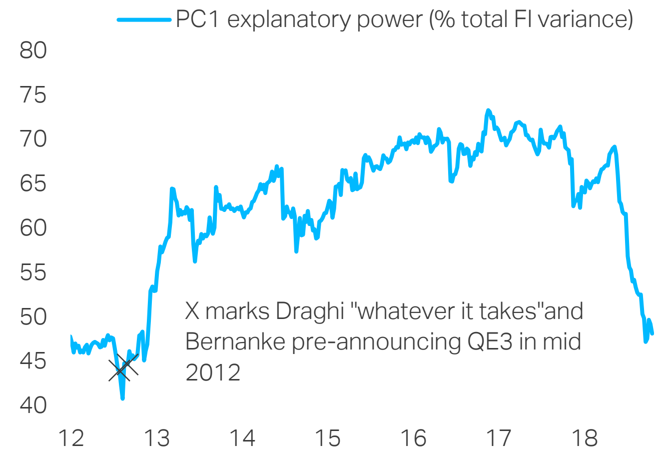
Idiosyncratic factors becoming more important. In Italy, fears over budget sustainability, credit rating and government stability are behind the widening in the BTP-Bund spread. Most importantly, for the first time, ECB asset purchases are not strong enough to bring the spread back down. But it's not just Italy. Term premium in the US has risen by 25bp since August. In the same period real 10y yields rose by 30bp, helped by a hawkish policy stance from Federal

Chart 1: QE tide is going out



Source: TS Lombard, Central Banks

Chart 2: FI market no longer floating on QE tide



Source: TS Lombard, Bloomberg

Reserve Chairman Powell. Part of the rise in real yields is growth, and should not be a drag (especially while the FOMC rate is still accommodative), but part is technical in nature: a rise in risk premium increases cost of debt, all-else-equal.

Higher debt costs not a material drag on S&P companies. In US Watch, Andrea Cicione used our discounted cash flow model of S&P500 valuation to show that a 100bp rise in the cost of debt would only warrant a 4.5% fall in stock prices. (Of course, although higher interest rates may not be a drag, the route to get there is likely to be volatile.)

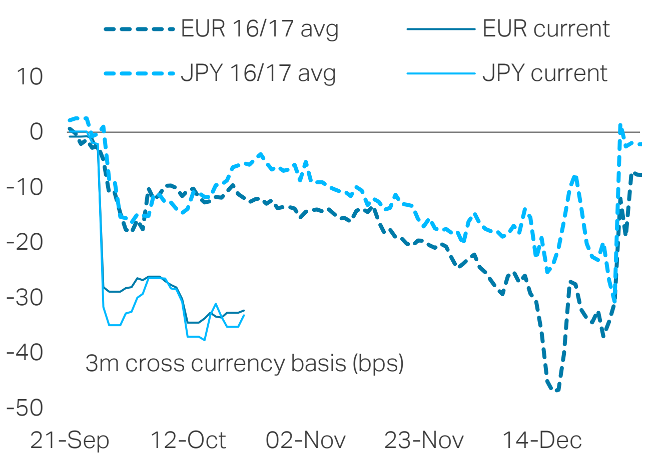
Source of stress is foreign dollar demand. Rather than rising US rates (so far) becoming a drag on US growth, the damage is offshore. EUR and JPY cross-currency basis widened by 30bp as the 3m date rolled over to year-end and have continued widening since then. If previous years are any guide, demand for USD at year-end will remain high and the basis is unlikely to narrow (Chart 3).

There is a structural reason for this: whereas US banks have to factor in daily balance sheets to leverage ratio calculations, EU banks only need do so at quarter-end dates. EU banks therefore have more opportunity to arbitrage funding markets in between these times. But it also means these banks are the same side when it comes to tidying up balance sheets, and borrowers will face a sharp fall in short-term USD availability into the year-end. The relationship between FX basis and USD performance broke down earlier this year, but with the basis widening there is a risk that USD begins to strengthen again.

EM dollar debt at risk from higher rates and higher USD. Such a USD move would trigger further pain for another category of offshore borrowers, as we explored in Global Financial Trends (Chart 4). Dollar lending to EM has more than doubled to $11.5tn since mid-2007; corporates have borrowed particularly aggressively and about two-thirds of EM external debt is denominated in USD. As a result, Fed policy has a large bearing on EM financial conditions and Fed tightening cycles have been one of the key triggers of EM crises in the past. Higher interest rates have already contributed to Turkey's fall into crisis.

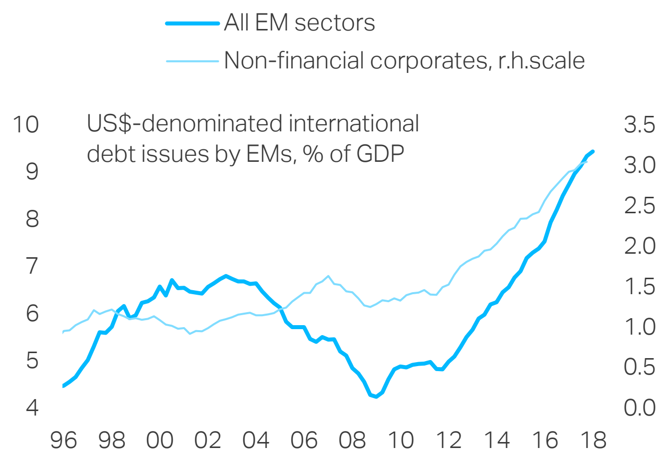
Tighter global liquidity is likely to increase the risk of an accident. In the US strong growth, tax cuts, dollar repatriation and still-accommodative policy ensure that liquidity is ample. Elsewhere the picture is much less rosy. Warren Buffett says that "It's only when the tide goes out that you know who's been swimming naked." The QE tide was a particularly high flood; now it is going out.

Chart 3: Basis tends to widen into year-end



Source: TS Lombard, Bloomberg

Chart 4: EM dollar debt binge



Source: TS Lombard, Datastream, BIS