The New Frontier
Quantitative Easing and the Low Yield Environment in Europe

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On 9 March 2015 the European Central Bank (ECB) embarked on its much-anticipated quantitative easing (EZ QE) program. The ECB now joins other major developed markets central banks in pursuing an asset-purchase effort. The ECB aims to re-ignite economic growth and counter downward-trending inflation that has plagued the region. However, the current environment in Europe is already characterized by very low—even negative—yields and the central bank’s operations will depress yields even further. In this paper, we discuss the backdrop for the ECB’s bond-buying program, as well as the implications for investors.
A Global Bond Bubble?

Since 1990, global bond markets have boomed while yields have progressively sunk (Exhibit 1). This secular trend recently dovetailed with a number of fundamental factors as well as the market’s expectation of QE to force yields to all-time lows in a number of regions across all segments of the fixed income market. Factors contributing to low yields globally include, but are not limited to:

- Low growth and inflation (Exhibit 2);
- A savings glut, due to increasing wealth in emerging markets and growing retirement savings by baby boomers in developed markets;
- A search for safety following the global financial crisis;
- New regulations limiting the ability of some investors to take risk other than fixed income; and
- A shrinking number of AAA-rated assets.

These factors have been most pronounced in the euro zone, where more than 25% of all sovereign bonds traded at negative nominal yields in February 2015. While negative yields were most common at the short end of the curve, rates in Germany were negative for maturities of up to 7 years (Exhibit 3).

The ECB launches EZ QE

It is in this environment that the ECB launched its quantitative easing (EZ QE) program on 9 March 2015, which will likely depress yields further. EZ QE will see the ECB and National Central Banks (NCBs) buy €60 billion in assets per month, including approximately:

- €10 billion per month of asset-backed securities and covered bonds, under the previously launched ABSPP and the CBPP3 programs;
- €6 billion per month of securities issued by European institutions (e.g., the European Financial Stability Facility and the European Investment Bank); and
- €44 billion per month of securities issued by euro zone governments.

The new program will last at least until September 2016, implying purchases of about €1.1 trillion in total, but is in fact open-ended and will be extended as long as inflation in the euro zone remains below the 2% target. The euro zone government bond market has a total of about €6.4 trillion of debt. The ECB has indicated it will only purchase bonds with a maturity greater than two years which limits the universe it can buy to €4.5 trillion (Exhibit 4). There is a limiting constraint on the ECB in that it has indicated it will not buy bonds with a yield below the deposit facility rate which currently stands at -0.20%. German 3-year notes currently yield -0.23% and hence would be ineligible for purchase.² This limit could potentially make it more difficult for the ECB to fulfill its purchase commitments.

EZ QE will strain some government debt markets more than others. Market volumes of the bond buying scheme will be carried out according to the shares of national central banks in the ECB capital key (referring to the paid-up capital of euro area countries only), not according to amounts of outstanding government debt. This is an important point, as the Bundesbank accounts for over 25% of
the ECB’s capital key, yet the German government bond market is smaller than the French and Italian markets, implying that annual QE purchases will be about 27.8% of the outstanding bonds in the German market versus 16.1% and 11.9% of the French and Italian markets respectively (Exhibit 5). Ironically, this implies that the EZ QE program could ease monetary policy most substantially in the countries with the smallest relative debt burdens, potentially exposing them to the most significant unintended consequences of negative interest rates.

What Are the Consequences of EZ QE?

There are several transmission mechanisms for EZ QE to promote a cyclical recovery of the euro zone economy. Of these mechanisms, we do not think that still lower interest rates in capital markets or more liquidity will do much, as interest rates are already very low and liquidity is abundant. The most obvious effect of EZ QE is the weakening of the euro against the US dollar and other currencies, which should lift exports (Exhibit 6). In combination with lower oil prices, gradually rising wages in parts of Europe and continuing structural reforms in Spain, Portugal, Ireland, Greece, and elsewhere,
a limited economic recovery seems possible, which also should reduce longer-term deflation risks.

While EZ QE may have limited impact on the real economy, it will be a meaningful factor for markets. The arrival of a large price-insensitive investor in European bond markets has already driven bond yields and credit spreads down dramatically. Importantly, this incremental demand might be difficult to satisfy, as many institutions need to hold sovereign debt to satisfy regulatory requirements related to their asset risk profile and capital considerations. Therefore, we must ask “Who will sell to the ECB?” According to ECB/IMF\(^1\) statistics, ownership of euro zone sovereign debt is composed of:

- 25% euro zone banks
- 22% EMU insurer and pension funds
- 20% foreign central banks
- 12% euro zone asset managers
- 8% ECB system
- 13% Other

Most of these investors are unlikely to be eager sellers, as government bonds have advantages in a tight regulatory environment when liquidity ratios are key and collateral is scarce. In fact, under Basel III, banks are required to satisfy the Liquidity Coverage Ratio and the Net Stable Funding Ratio requirements. Part of these liquidity requirements is a requirement to hold High Quality Liquid Assets (HQLA). As a result, banks are likely to be unwilling or unable to sell substantial amounts of the sovereign debt to the national central banks that will execute EZ QE on behalf of the ECB. Insurers are going to be similarly constrained by their regulators. As a consequence, the ECB likely will have to focus its purchases on foreign owners, with potentially negative implications for the euro exchange rate against other currencies assuming foreign sellers have not hedged their currency exposure. We expect scarcity premiums to rise across euro zone government bond markets.

**What Does This Mean for Euro Zone Investors?**

EZ QE has several consequences for euro zone investors, among them:

- Low and now negative interest rates in many bond markets make it nearly impossible to meet the return targets of insurance companies, pension funds, or foundations, as most of these investors have 70%–90% fixed income allocations and return targets of 3%–5%.
- The net present value of liabilities of corporate pension funds have risen dramatically, as the discount rates have followed interest rates down, obliging corporations to put more money into their pension plans. The “German Pension Finance Watch” of Towers Watson says the pension obligations of the DAX 30 companies have risen from €303.3 billion at the end of 2013 to €391.7 billion at the end of 2014 (+29.1%), while assets only rose from €198.2 billion to €213.5 billion (+7.7%), reducing the funding ratio from 65.3% to 54.5%.
- From the perspective of how financial markets operate, there is also a risk that the purchases of sovereign debt by central banks could lead to shortages of debt that is suitable for use as collateral for secured funding. In such transactions, banks and investors often post collateral such as sovereign debt to give their counterpart security against a credit or settlement loss. If there is insufficient collateral available, it could become more difficult for financial institutions to transact with each other, thus reducing liquidity in markets precisely when the ECB is seeking to increase the availability of funding to the economy.

Despite these pressures, the “Great Rotation” from fixed income to equities has not taken place.

- Recent regulation prevents institutional investors from risk-taking via equities, due to high risk capital requirements for such investments. As a consequence, their main allocation change has been a widening of their universe, with rising investments in higher-yielding global and emerging markets fixed income.
- This has come at the expense of European fixed income, placing increasing margin pressure on European fixed income asset managers. We are not yet at the point where fixed income funds will have a zero yield, but that is a reasonable risk to contemplate if interest rates stay at current levels for a sufficiently long period of time.
- Illiquid asset classes have fewer fair value accounting and regulatory constraints and also have seen higher allocations from euro zone investors. Investments in real estate, new energy, timber, leveraged loans, and other alternatives have risen dramatically in the last years. Only the future can tell if these changes were wise decisions in the long run, as there are reasons why illiquid asset classes earn an illiquidity premium.

Looking beyond the euro zone, EZ QE could also make US fixed income instruments more attractive to investors (both domestic and foreign) due to the higher yields. This relative value opportunity could decrease the impact of any steps the US Federal Reserve might take to normalize monetary policy in the United States in coming quarters.
Conclusion

Fixed income yields have been declining for decades. In the euro zone, this has combined with a weak economic outlook and rising demand for limited safe assets to push yields to historic lows, including negative territory for 25% of all sovereign bonds. The announcement of EZ QE in late January pushed yields down further and its launch on 9 March 2015 will continue to depress them, as annual purchases of government bonds will be around 18.4% of the outstanding bonds with maturities of greater than 2 years. The effects could be even more substantial in countries like Germany where the ECB capital key will lead to purchases that are much larger than the share of government debt relative to the euro zone sovereign debt market. Most euro zone government bonds are held by entities such as banks, insurers, pension funds, asset managers, and central banks that are likely to be reluctant sellers, as government bonds are helpful for liquidity ratios and as collateral. We expect that the ECB and NCBs will pay significant scarcity premiums as a result.

For euro zone investors, low yields make it nearly impossible to meet return targets and force down funding ratios of pension plans. Despite this pressure, regulatory constraints have prevented a rotation from fixed income to equity investments. Instead, euro zone investors have allocated more capital to global and emerging markets fixed income investments and increased their investments in illiquid asset classes like real estate and alternative energy, which carry fewer regulatory constraints. Over time, we will learn whether these allocation changes will prove to be prescient or a costly unintended consequence of unprecedented monetary policy decisions.

Notes
1 Source: ECB, IMF, Commerzbank Research, as of 26 February 2015.
2 Source: Bloomberg, as of 10 March 2015.

Important Information
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