Short-Term Rates Becoming Unexpectedly Low In Europe

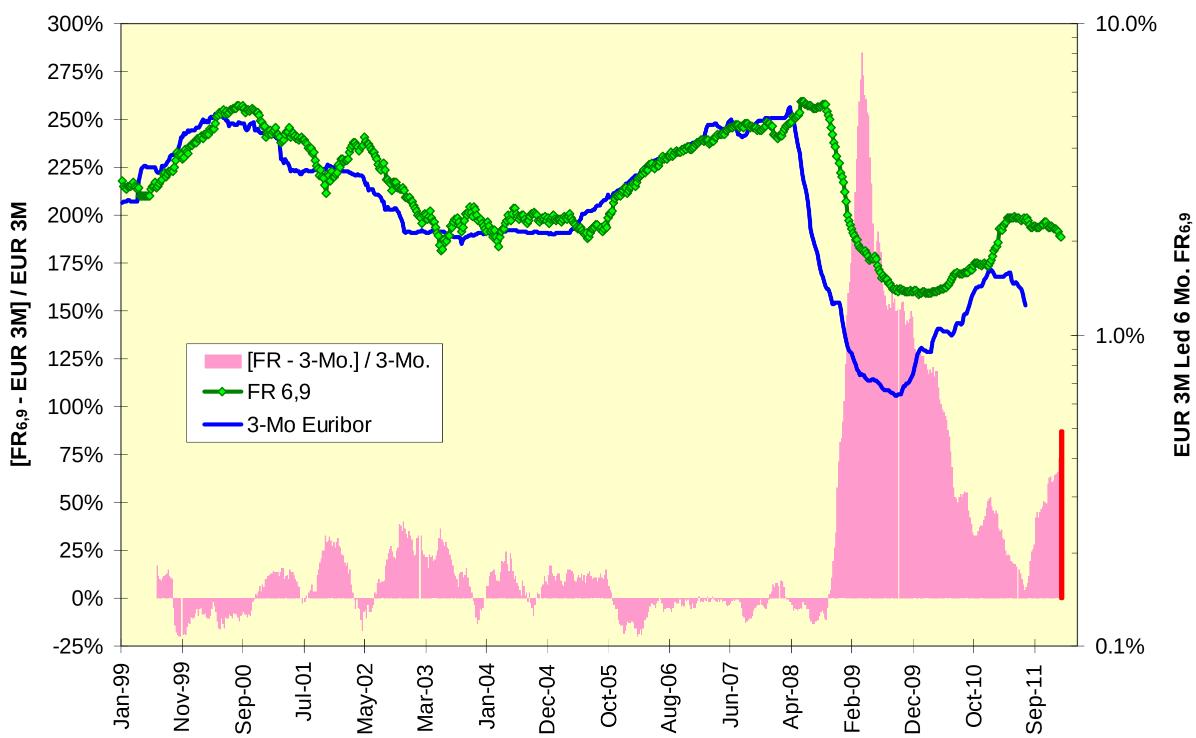
The Same Bullish "Perma-Expectations" Trade Seen Elsewhere Will Appear In Europe

Just as I expected, Eurozone short-term interest rates are becoming unexpectedly low. The condition I have dubbed "perma-expectations" of higher short-term interest rates just around the corner first appeared in Japan more than a decade ago and then in the U.S. and U.K. in 2008-2009. As I noted in September 2011's Low Interest Rates: Perma-Expectations No More, they are disappearing in the U.S. and the markets have resigned themselves to the Federal Reserve's heavy foot on the accelerator.

Today The World, Tomorrow Europe

The gap between Euribor forward rates between six and nine months and actual three-month Euribor six months from now has been expanding at a rate not seen since the 2008 financial crisis. I marked last week's datum in heavy red on the chart below. This evidence of unexpectedly low short-term interest rates should be construed bullishly: The rational expectations hypothesis holds only unexpected changes in monetary policy such as the Draghi ECB's move toward lower interest rates can have actual macroeconomic repercussions.

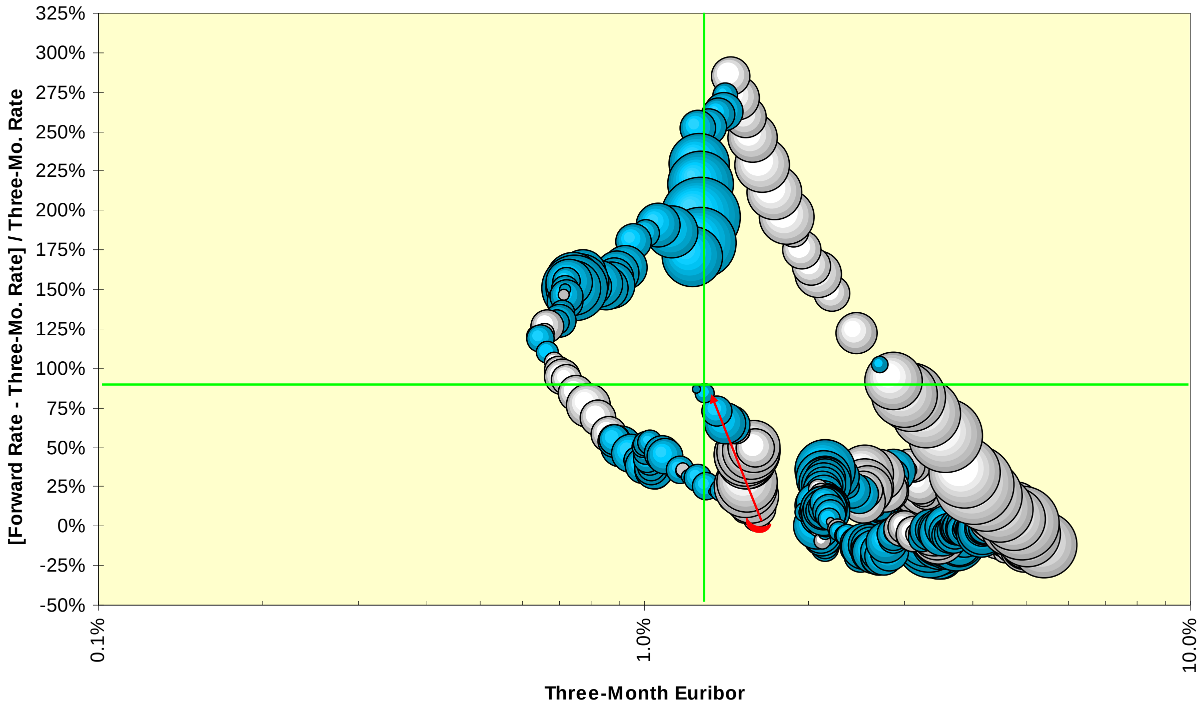
Unexpectedly Low Rates Building In The Eurozone



Capital Market Consequences

We do not trade macroeconomic consequences; we trade actual markets. If we map three month-ahead returns on the MSCI-Barra EMU index in euro terms as a function of this normalized rate gap and the actual level of three-month Euribor itself, we can see how we are moving into a bullish zone. He blue bubbles in the chart below depict positive prospective returns; the white bubbles depict negative ones. The diameter of the bubbles corresponds to the absolute magnitude of the return. The last datum used is highlighted in red and the present environment is highlighted with a green bombsight.

Eurozone Three Month-Ahead Equity Returns As A Function Of
Three-Month Euribor And Forward-Rate Gap



The present course of action is moving from negative prospective returns toward a zone of positive ones. Any further expansion of the rate gap will make the configuration even more bullish. I should add that a corresponding map for German 7-10 year Bund returns has been in a bullish configuration for months already.

If we have learned anything over the past four years it should be central banks are willing to panic to preserve financial markets. They have learned the hard way, as have we all, bear markets can destroy real economic activity. The opposite, as I have argued loud and often, is not true, though: Bull markets can exist independently of the real economy.

The situation is doubly critical in the Eurozone as insolvent sovereigns rely on bond purchases made by insolvent commercial banks to finance themselves. As the money to fuel this charade needs to be printed somewhere, the ECB will have to drop any and all pretense of its one mandate and start printing. As the response to money-printing in the U.S. was bullish in 2009, I expect the same to happen here.