

Have you ever had a nightmare that actually came true? Probably not, but the imagination is scary.

5y5y inflation swaps:

When the ECB introduced negative interest rates on 11th of June 2014, a note was published on its website specifically explaining the move and its consequences. As a main reason for introducing negative deposit rates it was said that the euro area's "expected inflation to remain considerably below 2% for a prolonged period". Only two months later in August 2014 at the Jackson Hole Conference, Draghi mentioned concern over EUR 5y5y inflation swap rates dropping the first time in its history below 2% just days before the conference started. At the announcement of the negative rates, however, EUR 5y5y inflation swaps were fairly anchored at above 2%. Since then 5y5y inflation swaps in most currencies have dropped significantly.

EUR 5y5y swaps dropped from 2.1% in July 2014 to just 1.66% in January 2015. US 5y5y swaps fell from 2.8% in July 2014 to 2.2% in January 2015. And CHF 5y5y swaps mark an incredible decline from 2% at the beginning of 2014 to just 0.4% in January 2015. In particular the CHF cap removal on 15th January caused another drop of 20 basis points on concerns over the current account and its economic long-term implications. Graph 1 depicts the decline in long-term inflation expectations (white line USD, yellow line EUR, green line with separate y-axis CHF).

Graph 1.)



Inflation expectations vs. exchange rates:

The cause and effect relationship is interesting when thinking about Draghi's rate decisions in 2014 and the subsequent changes in long-term inflation expectations. Either Draghi and his team acted way in advance and believed that inflation expectations are too high at 2% on the day of negative rates announcement or, not to exclude, negative interest caused inflation expectation to drop. A nightmare that comes true... The latter would mean exactly the opposite of what the ECB intended, namely that with negative interest rates banks would rather lend their excess cash than paying interest to hoard it at the central bank.

On the other hand, it is interesting to see what the negative rate decision by the ECB has meant for exchange rates. EURUSD plummeted steadily over the year after the ECB's decision in June 2014 from 1.35 EURUSD to a twelve year low of 1.11 EURUSD in January 2015. Another driver of this fast depreciation of the Euro against the US dollar was also the expectation that the Federal Reserve would move in the opposite direction with a rate hike in mid 2015. Graph 2 compares the almost parallel move of EUR 5y5y inflation swaps with the EURUSD exchange rate. Could it hence be true, under ceteris paribus, that negative interest rates cause inflation expectations to drop and the currency to devalue in ways that are disproportionately to a similar rate cut in the positive area?

Graph 2.)

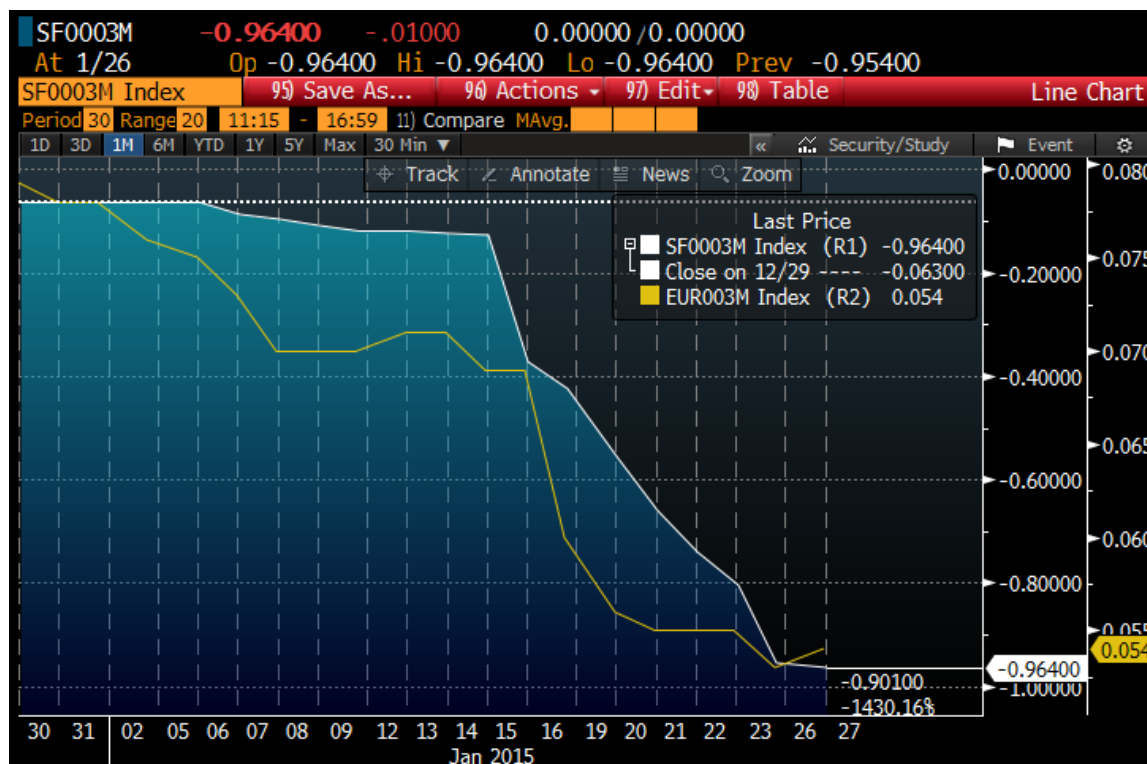


Not Quantitative Easing matters, negative Interest Rates do!

The Euro story is very exciting and one should closely watch when EURUSD is approaching parity. However, the recent SNB's step to remove the EURCHF cap of 1.20 and its decision to lower interest rates from 0.25% to -0.75% to the band of -0.25% to -1.25% could be of even more importance, as it would mean that the CHF can only be traded in negative terrain, since even the upper range lies in negative territory. This is completely new to money markets. And now let's revisit the ECB's statement on its decision to

introduce negative interest rates: "Isn't it possible for banks to avoid the negative deposit rate? [...] It has only two options: To hold the money on an account at the central bank or to hold it as cash. [...] And to hold it as cash is not cost-free either, as a bank need a very safe storage facility to warehouse the banknotes." Swiss banks have to seriously ask themselves what to do with their excess reserves in CHF. How harmless the ECB's negative deposit rate is in comparison the Swiss negative interest rates shows 3-month Libor. Graph 3 compares CHF 3-month Libor (white line and 1st right y-axis) with EUR 3-month Libor (yellow line and 2nd right y-axis). Even though the Euro deposit rates are negative, EUR 3-month Libor is trading in positive territory. CHF 3-month Libor, however, is currently as deep as 1% negative - it literally feels like holding a burning fireball in your hands that you want to get rid of ASAP.

Graph 3.)



Outlook:

Interestingly, at the beginning of January 2015 the CHF 3-month Libor was at around 0%, although interest rates were targeted between -0.75% and 0.25%. Meaning banks were not willing to lend CHF at negative rates even though the target interest rate by the SNB was -0.25%. This has clearly changed now. SARON - Swiss Average Rate Over Night - traded at -1.693% on 23rd of January 2015 and sight deposits of domestic banks with the SNB have increased from CHF mio 325,000 On 9th of January 2015 to CHF mio 380,000 on 23rd of January 2015, as published in a press release by the SNB on January 26th. The increase in sight deposits might have resulted from less negative interest rates at the SNB than in the market. This would mean that the unwillingness to hold CHF is already on the go - the ball is on fire.

Regards,

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