Financial markets

Downturn in financial markets against a backdrop of monetary policy normalisation

The Federal Reserve (Fed) is ahead of the European Central Bank (ECB) in the normalisation of its monetary policy. The Fed raised its base rate on three occasions in 2018, and could increase it again in December, as American inflation is above the 2% target and the unemployment rate remains very low. The European Central Bank is continuing its quantitative easing programme until December and will end it in January 2019, as the economic situation remains favourable despite a slowdown in activity in the Eurozone and with core inflation below the 2% target.

Outstanding loans continue to rise despite disparities within the Eurozone. European banks are expecting credit terms to tighten after their recent easing.

The stock market indices of the advanced countries slipped back in October, with NASDAQ suffering its biggest monthly losses in 10 years. In emerging countries confronted with the flight of capital and the rise of the dollar, the indices are generally down, except in Brazil.

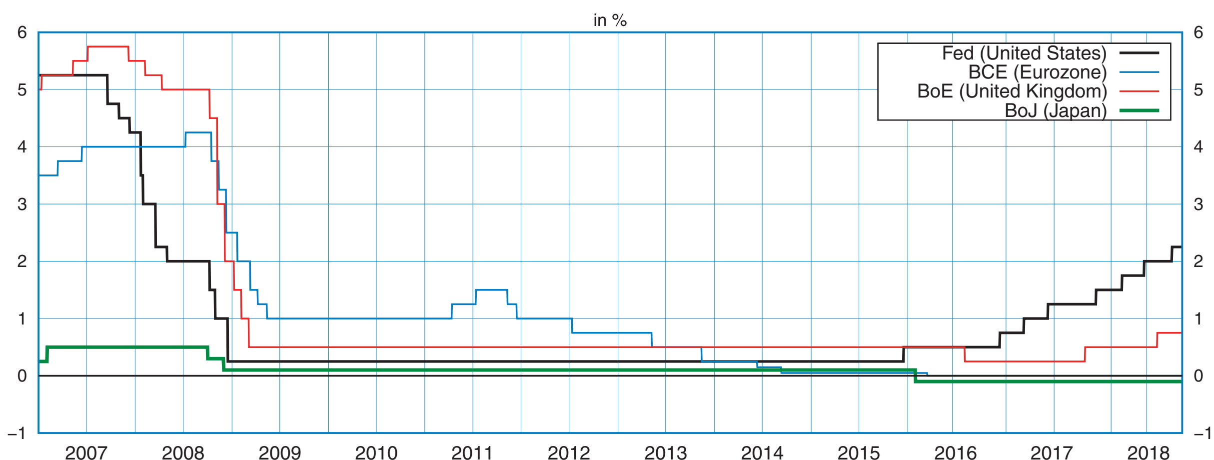
The euro has been depreciating against the dollar since the end of April and stabilised at around $1.14 in November due to the slowdown in the Eurozone, the expected rise in the Fed's base interest rates and the increase in American sovereign yields. The pound stabilised at around £0.88 to €1. For forecasting purposes, the euro exchange rate has been set at $1.14, £0.88 and 130 yen. The real effective exchange rate for French exporters should therefore fall in Q4 2018 and to a lesser extend in H1 2019.

The Federal Reserve continues to normalise its monetary policy

Having already raised its base rate on three occasions in 2018 (*Graph 1*), the Fed is expected to raise it again after its next Monetary Policy Committee meeting on 18 and 19 December 2018. Another two rises are then expected to occur during the forecasting period, in March and June 2019. The Fed is maintaining and gradually stepping up its efforts to reduce its balance sheet, which currently stands at $4,200 billion, at a rate of $50 billion per month in Q4 2018. This policy has been encouraged by inflation being above 2% and a very low unemployment rate that is below the usual estimates of the structural rate.

This tightening of monetary policy is adversely affecting certain emerging countries, such as Argentina and Turkey, and leading to the repatriation of capital to the United States. The scale of these withdrawals of capital could be increased by the fact that recent years have seen massive influxes of capital into emerging countries, corresponding to the quest for higher returns in a

1 - Base rates of the main central banks



Sources: Fed, BCE, BoJ, BoE

context of low interest rates. The Turkish lira has lost over 40% of its value since the beginning of the year, for example, as has also been undermined by the American sanctions. Confronted with the rise in US base rates and given the depreciation of their currencies and withdrawals of foreign capital, emerging countries are being forced to raise their own base rates. Base rates in Turkey rose sharply in October 2018, but not in Brazil where the financial conditions have improved (*Graph 2*).

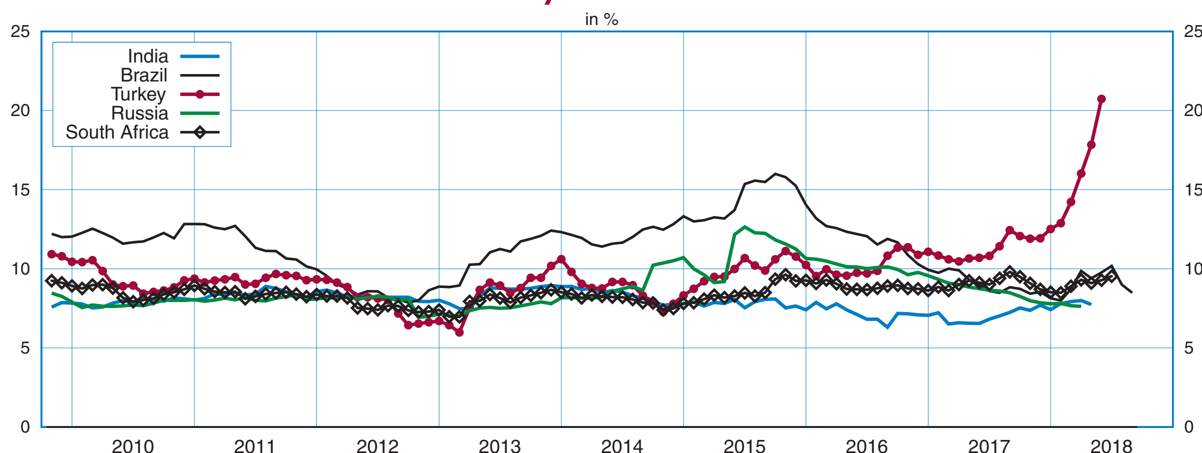
The European Central Bank is following in the Federal Reserve's footsteps

The ECB has confirmed the reduction of its securities purchase programme to €15 billion per month from October to December 2018, and the subsequent stoppage of this programme in January 2019. The next rise in its base rates is now expected before the end of 2019. However, the normalisation to come remains dependent on inflation being in line with expectations. In November 2018, core inflation continued to be virtually stable in the Eurozone at 1.0%, below the 2% target. The 10-year French inflation forecasts by the financial markets have increased slightly, to 1.5%. Within the Eurozone, the ongoing quantitative easing programme is keeping the interbank rates close to the deposit facility rate and the volume of transactions on the interbank market remains very low, at between €5 and €10 billion traded per day.

Sovereign yields are responding to the normalisation of monetary policies

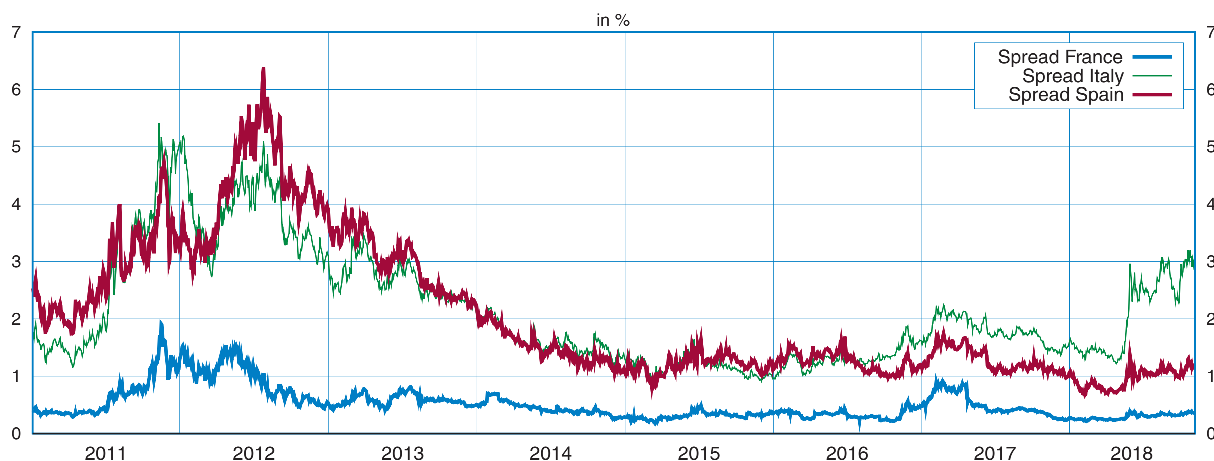
Whereas US monetary policy has caused American interest rates to rise, the German and French rates remain stable. Uncertainty over Italian fiscal policy has caused Italian interest rates to rise since 2018: the spread between the German and Italian sovereign bonds now stands at around 300 basis points (*Graph 3*), a level not seen since the beginning of 2013. There has been hardly any contagion, however: the Spanish and Portuguese rates have barely risen.

2 - Ten-year interest rates



Sources: CB, Eurostat, ICE Bank of America Merrill Lynch, OECD

3 -Spreads in relation to the Bund



Source: DataInsight

International developments

Favourable outlook for credit markets

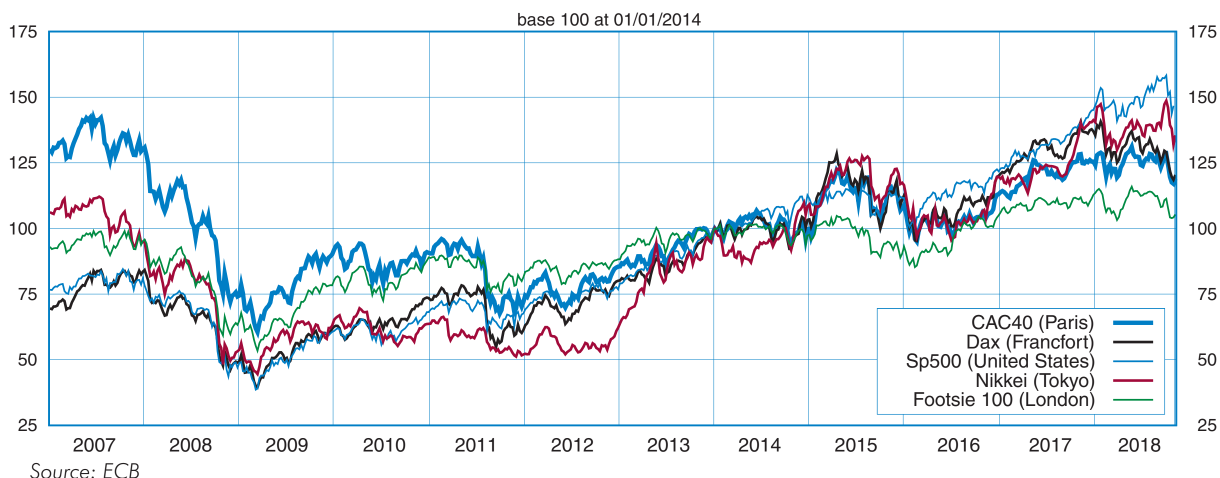
Credit terms continue to be very favourable in the Eurozone, despite persistent disparities. Outstanding loans to non-financial corporations in the Eurozone continue their uninterrupted rise that began in mid-2015. Outstanding loans are continuing to grow at a vigorous rate in France (+6.3% year on year in October) and in Germany (+5.5% year on year in October); they are increasing again in Italy (+1.6% in October) and remain stable in Spain. Lastly, the interest rates charged to companies are stabilising in the four countries, at around 1.3% in Germany, between 1.4 and 1.5% in France and Italy, and at 1.8% in Spain.

France still stands out from its main European partners due to the buoyancy of its household credit and corporate lending. Moreover, the rates for new loans to French households dropped slightly in 2018, from 1.61% in January to 1.51% in October. According to the Bank Lending Survey (BLS), credit terms have tightened slightly in the Eurozone and this trend is expected to continue in Q4 2018. Corporate loans could therefore slow in the Eurozone at the end of 2018.

Downturn in stock market indices

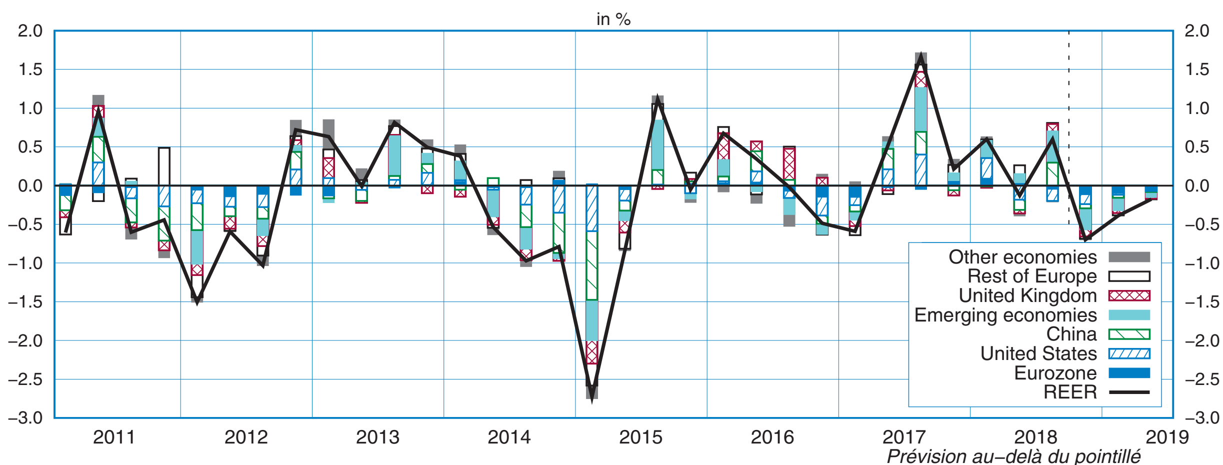
The stock market indices of advanced countries slipped back in October (*Graph 4*). NASDAQ suffered its biggest monthly drop since October 2008 and the S&P 500 recorded its largest monthly losses since January 2016. Possible explanations for this correction include higher interest rates,

4 - Stock market indices of the advanced countries



Source: ECB

5 - Quarterly changes in real effective exchange rate (REER) in France and its main contributing components



Source: Banque de France, national statistical institutes, INSEE calculations

enterprises' earnings sometimes being worse than expected and heightened vigilance concerning the valuations attained.

The downturn in emerging market indices over the past few months points towards a reversal of capital flows, some of which are withdrawals from emerging countries for repatriation to the United States, attracted by the increase in the American base and sovereign rates, the rising dollar and the American government's fiscal measures.

Consequently, the shares of the most indebted enterprises, especially in emerging countries, have dropped sharply. In addition, the MSCI EM (Morgan Stanley Capital International Emerging Market) stock market index, which measures market performance in 24 emerging countries, fell by 8.9% in October.

The euro is stabilising against the dollar at the end of the year

The euro depreciated against the dollar in Q2 2018 and then stabilised at around 1.14 dollars during the month of October: a level that will be used for forecasting purposes through to late June 2019. This depreciation is explained by the differences in growth and monetary policy between the Eurozone and the United States. The recent rises in the dollar and in the Fed's base rates have led to substantial depreciations of emerging currencies and of the Turkish lira and Argentinian peso, in particular. The real effective exchange rate (REER) for French exporters (*Graph 5*) is expected to fall in Q4 2018 (–0.7%) and to a lesser extend in H1 2019 (–0.4% in Q1 and –0.2% in Q2) as a result of the depreciation of the euro and lower inflation in France than in the rest of the Eurozone. ■