THE CARLYLE GROUP
GLOBAL ALTERNATIVE ASSET MANAGEMENT

Carlyle Comment

September 4, 2014

ECB QE: Expect Corporate Valuation Gap with U.S. to Close Over Five Years

By Jason M. Thomas

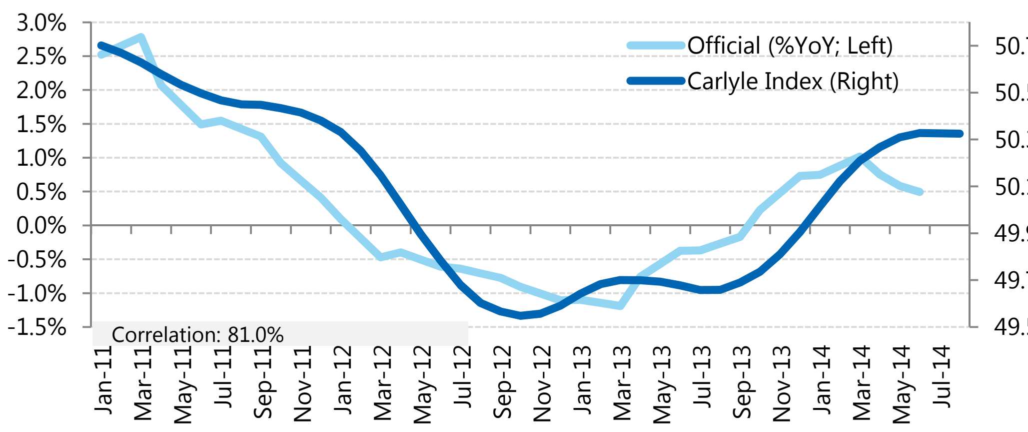
Today, the European Central Bank (ECB) Governing Council announced a 10bp across-the-board reduction in its policy interest rates and its intention to purchase asset-backed securities (ABS) and covered (mortgage) bonds which combine to account for over €2 trillion in euro area financial assets. With deposit rates at -0.2%, the ECB will be giving banks euros and penalizing them if they do not lend them out in turn.

As ECB President Draghi recently alluded in Jackson Hole, monetary policy in the U.S. and Europe seems likely to diverge sharply over the coming years.[1] The Fed plans to finish asset purchases in October 2014 and start raising rates by mid-2015; conversely, the ECB is putting additional stimulus in place and leaving rates on hold. This divergence could eventually give rise to a large gap in policy interest rates between the world's two largest economies, with cash rates in the U.S. significantly exceeding those in Europe.

At first glance, a large gap in short-term interest rates would seem likely to place downward pressure on the euro exchange rate, as cash balances flee Europe in search of higher relative yields in the U.S. However, the experience from the last Fed tightening cycle suggests that a more sizeable shift could occur in the relative valuation of corporate assets. As expected Fed policy rates increase, so too will the discount rates applied to future dollar-denominated cash flows, which will exert downward pressure on valuation ratios (Ebitda or earnings multiples). With the ECB on hold indefinitely, there will be no corresponding downward pressure on valuations; indeed market reaction to the decision suggests discount rates are likely to fall. The result is likely to be a narrowing in the European valuation discount in manner similar to that which occurred between 2003 and 2006.[2]

While some depreciation in the EUR/USD exchange rate from current levels is likely, countervailing forces will likely limit the scale of the euro's descent. Since the crisis, the euro has actually tended to *strengthen* in response to ECB stimulus. By improving growth prospects and debt sustainability, lower interest rates have attracted foreign capital and placed upward pressure on the exchange rate.[3] While the uncertainty surrounding the current outlook is especially great due to the situation in Ukraine, current Carlyle portfolio data suggest a flattening of trend growth rather than a new leg down (**Figure 1**). In this context, a relatively modest depreciation could boost external demand and stabilize growth perceptions in a way that increases the relative attractiveness of euro-denominated assets.

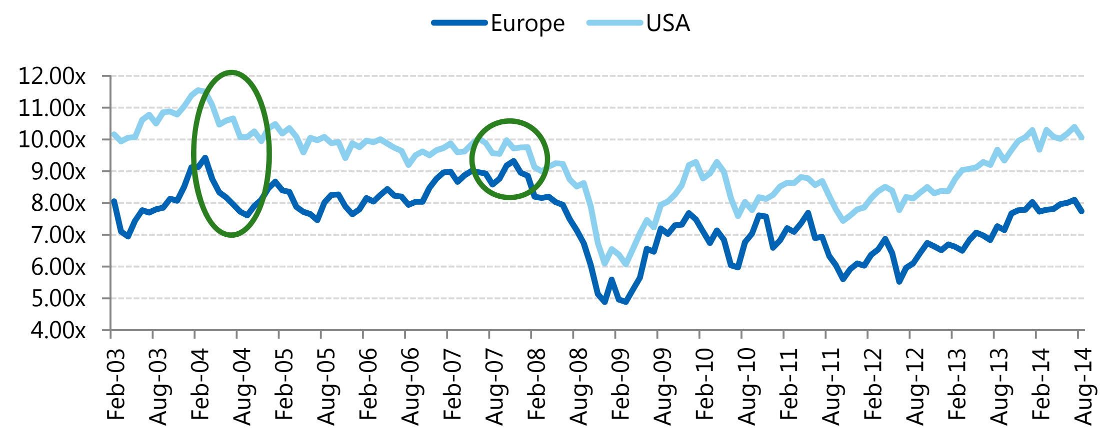
Figure 1: Euro Area GDP Growth: Official Data and Carlyle European Portfolio Index



1. Draghi, M. (2014), "Unemployment in the Euro Area," Federal Reserve Bank of Kansas City Policy Symposium.
2. S&P Capital IQ, September 2, 2014. Value-weighted averages of U.S. and European broad index constituents.
3. This was most visible during 2012, when the euro appreciated sharply (+12% in three months) following Draghi's "whatever it takes" speech and the announcement of the ECB sovereign debt backstop.

The performance of the euro between 2002 and 2007 also casts doubt on the likelihood of an especially large downward adjustment in the euro exchange rate. Between 2002 and 2006, U.S. policy interest rates increased by 4 percentage points relative to euro rates (from cash rates 1.5% below to 2.5% above those in Europe), but the euro actually *strengthened* over this period from $1.08 to $1.36.[4] Lower relative yields in the euro area were offset by 0.9% per year lower average inflation and significantly better trade performance. While current circumstances seem more favorable to depreciation, especially given the likely emergence of the euro as a funding currency, near-zero inflation and a large current account surplus are again likely to impede the large nominal declines some envision.[5]

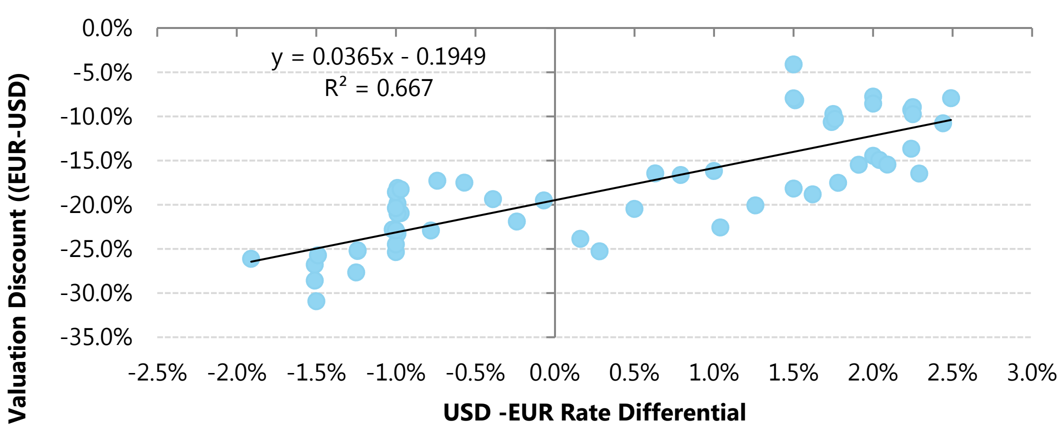
Figure 2: TTM Ebitda Ratios, U.S. and European Public Businesses



It seems more likely that a persistent and growing interest rate differential will lead to a shift in valuation ratios. When euro cash rates exceeded those in the U.S. by 1.5% in 2003, the average enterprise value of European corporate businesses was nearly 30% less than that of the average U.S. firm. By the time the Fed finished hiking rates by 4.2%, cumulatively, to bring U.S. cash rates 2.5% above euro yields, the valuation discount had all but disappeared (**Figure 2**).[6] It is important to note that the gap was closed mainly on the U.S. side, with European valuations remaining roughly constant while U.S. valuations declined. Similar dynamics could be expected today.

Figure 3 plots the relationship between valuation and interest rate differentials. Over the 2003-2006 period, changes in the interest rate differential explained two-thirds of the monthly variation in the valuation differentials. Every one percentage point increase in the USD-EUR interest rate differential shaved 3.65% off of the EUR corporate valuation discount. If the same relationship obtains in the current environment, a cumulative 4% increase in relative dollar yields would be associated with a narrowing of the current 23% valuation discount to just 8%, a level more consistent with the 1.5% annual difference in real GDP growth.[7]

Figure 3: Relationship Between Interest Rate and Valuation Differentials



4. Carlyle Analysis of ECB (Main Refinancing Rate) and Federal Reserve (Effective Fed Funds Rate) data; Fed, H.10, Foreign Exchange Rates.
5. Brooks, R. et al. (2014), "FX Views: Revising down our EUR/$ forecast," Goldman Sachs Research.
6. S&P Capital IQ, September 2, 2014. Value-weighted averages of U.S. and European broad index constituents.
7. Carlyle Analysis of IMF 2014 Database.

Economic and market views and forecasts reflect our judgment as of the date of this presentation and are subject to change without notice. In particular, forecasts are estimated based on assumptions, and may change materially as economic and market conditions change. The Carlyle Group has no obligation to provide updates or changes to these forecasts.

Certain information contained herein has been obtained from sources prepared by other parties, which in certain cases have not been updated through the date hereof. While such information is believed to be reliable for the purpose used herein, The Carlyle Group and its affiliates assume no responsibility for the accuracy, completeness or fairness of such information.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of clients of The Carlyle Group. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual investors.

Contact Information:
Jason Thomas
Director of Research
Jason.Thomas@carlyle.com
(202) 729-5420