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# Euro Funding Ample, But Investment Lacking

### Eurozone policymakers should not misread reverse Yankee issuance

- Borrowing in euros doesn't mean investing in the Eurozone
- Retained earnings in Eurozone only just recovering from 2023 US liquidation
- Global FDI continues to be undermined by high dollar rates

## Tight dollar financial conditions driving FX funding

The European Central Bank's Q1 lending survey pointed to ongoing difficulties with demand for credit in the Eurozone. Consequently, any type of rise in borrowing by the private sector, be it through loans or bond issuance, is often seen as reason for celebration. This week, financial media picked up on the wave of so-called reverse Yankee issuance, whereby US firms are now taking advantage of low borrowing costs in the Eurozone to issue bonds.

Optimists may wish to frame such issuance in the context of investment and growth. For example, US firms may be building up resources for mergers and acquisitions and deploying some leverage in the process. If trends from recent Purchasing Manager Indices (PMIs) continue, Eurozone growth is showing some improvement – led by the consumer – and there is scope for US (or global) firms to expand accordingly.

We take a far more cautious view on macro factors and think the pick-up in issuance simply reflects cost advantages. For a similar credit profile and factoring in the cost of FX hedging via cross-currency basis, it's no surprise that US-based borrowers can obtain funding on more attractive terms. Furthermore, the ‘investment case’ globally remains fundamentally flawed. Traditionally, companies can fund new cross-border investments using retained earnings, which comprise a core component of countries’ FDI. In interest-rate terms, the Federal Reserve's G10-leading tightening cycle increased the opportunity cost of not repatriating earnings back into the US, and accounting for still-advantageous tax terms.

Several quarters on, as the Fed looks set to embark on an easing cycle, there's no sign of such trends recovering – at all. Much like our frustrations with the ongoing US bias in asset allocation, retained earnings are not picking up markedly in core markets: the risk profile of FDI is considered even higher than conventional portfolio investment and there is no appetite to increase it, irrespective of dollar valuations or general reflation opportunities.

The impact of higher US yields is more apparent in Eurozone FDI figures than for other core economies. Exhibit #1 shows the evolution of retained earnings (classified as a liability item on balance-of-payments data) on a quarterly basis. Over the past decade, we can see that there has only been a single quarter during which non-US investors pulled earnings. The trigger at the time was the ECB's move towards negative rates, though as the rest of the world was in a similar monetary prognosis at the time, the outflows were not sustained.

In contrast, investors have pulled funds from the US on multiple occasions. There was a sustained period of outflows through 2016, likely in anticipation of tax changes which incentivised repatriation. However, no quarter can compare to Q1 and Q2 2023 last year, during which corporates pulled almost EUR70bn in earnings from the Eurozone as interest-rate gaps opened sharply in favour of the US. Despite ample Eurozone savings, such withdrawals would have also represented a material tightening in Eurozone financial conditions, which the ECB is still reluctant to offset through rate cuts. The latest data indicate a return of only EUR 17bn in retained earnings through H2 2023 by US firms. In contrast, non-US retained earnings have remained positive throughout, and there is not enough evidence to suggest that there is a significant pullback from the Eurozone.

As much of the FDI into the Eurozone from outside the currency union would likely come from core savings-heavy economies such as Switzerland, Sweden and across Asia-Pacific, the EUR in contrast enjoys a strong rate advantage (or at least is not at a significant disadvantage) against most of those – especially the lattermost. With conventional US corporate behaviour over the past year to pull funding from the Eurozone to earn higher carry on US yields or even invest in a growing US economy, rather than reinvest existing euros locally, there is very little fundamental reason to expect that they are now suddenly borrowing euros for similar activities. The economic case relative to the US is not there.

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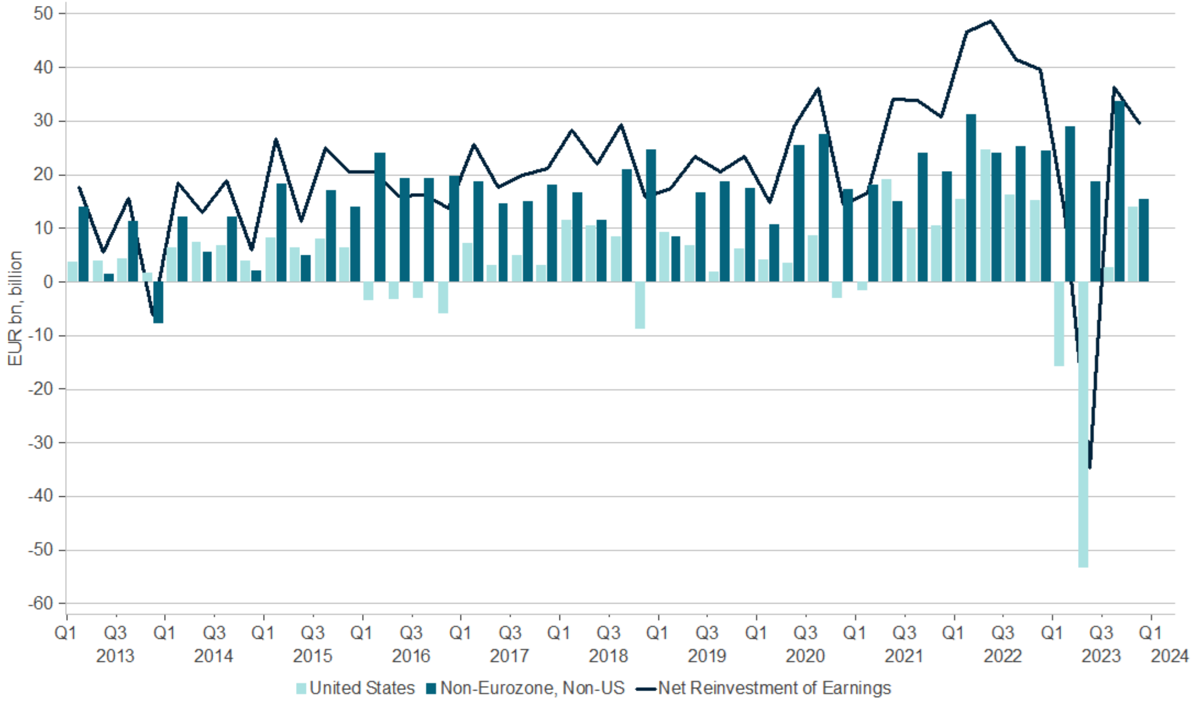
**Exhibit #1: Eurozone FDI - Retained Earnings**



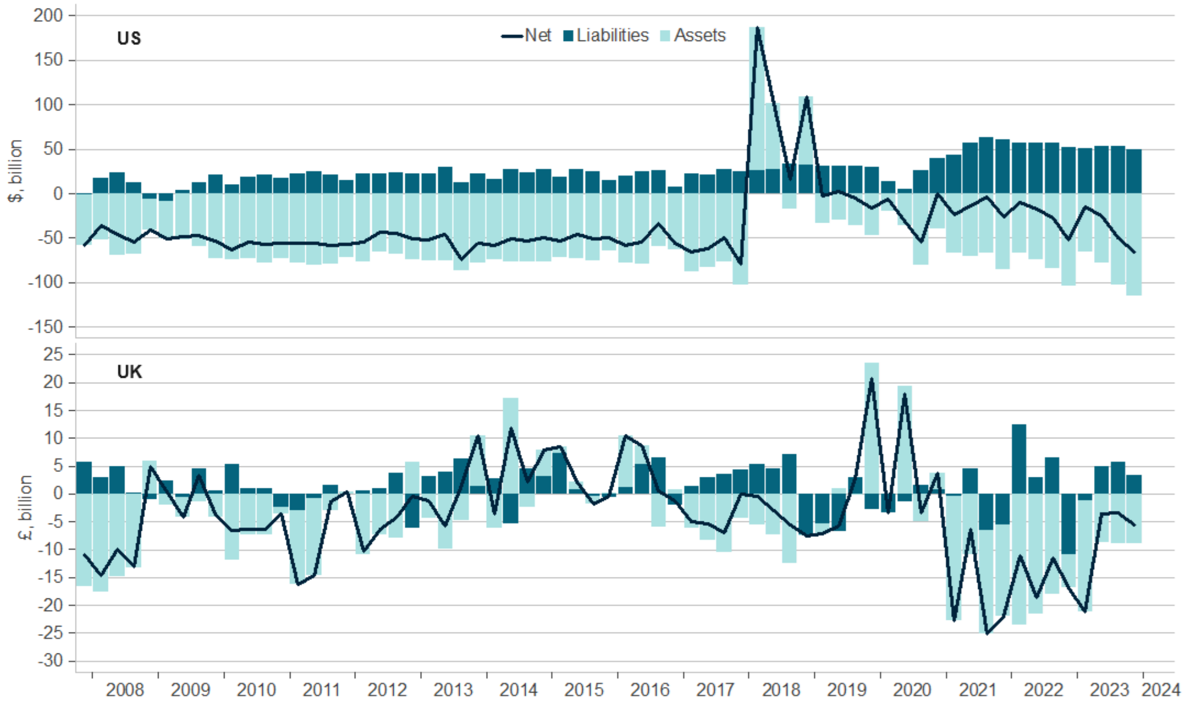

Source: Macrobond, BNY Mellon

US corporates may be pulling earnings out of the Eurozone, but this does not appear the case on an aggregate basis. US firms' reinvestment of earnings overseas reached record levels in H2 2023 (exhibit #2, upper), even though US yields were at the highs. This marks the first time on record that US firms generated retained earnings of more than $100bn for two consecutive quarters. It may also be a sign that yields are not the whole story.

While geopolitics are generating onshoring for the US, re-shoring or near-shoring are also strategic imperatives for US industry, and this is keeping earnings offshore. Furthermore, manufacturing and technology sectors are leading such efforts and profitability has been strong, so such FDI trends would also be a confirmation of the 'US exceptionalism' story.

In contrast, we can see the UK has struggled with keeping retained earnings onshore throughout the last few years (exhibit #2, lower). Higher sterling interest rates in 2023 may have helped keep more funds onshore in the UK, especially compared to the situation in the Eurozone, but Europe in general continues to face investment headwinds.

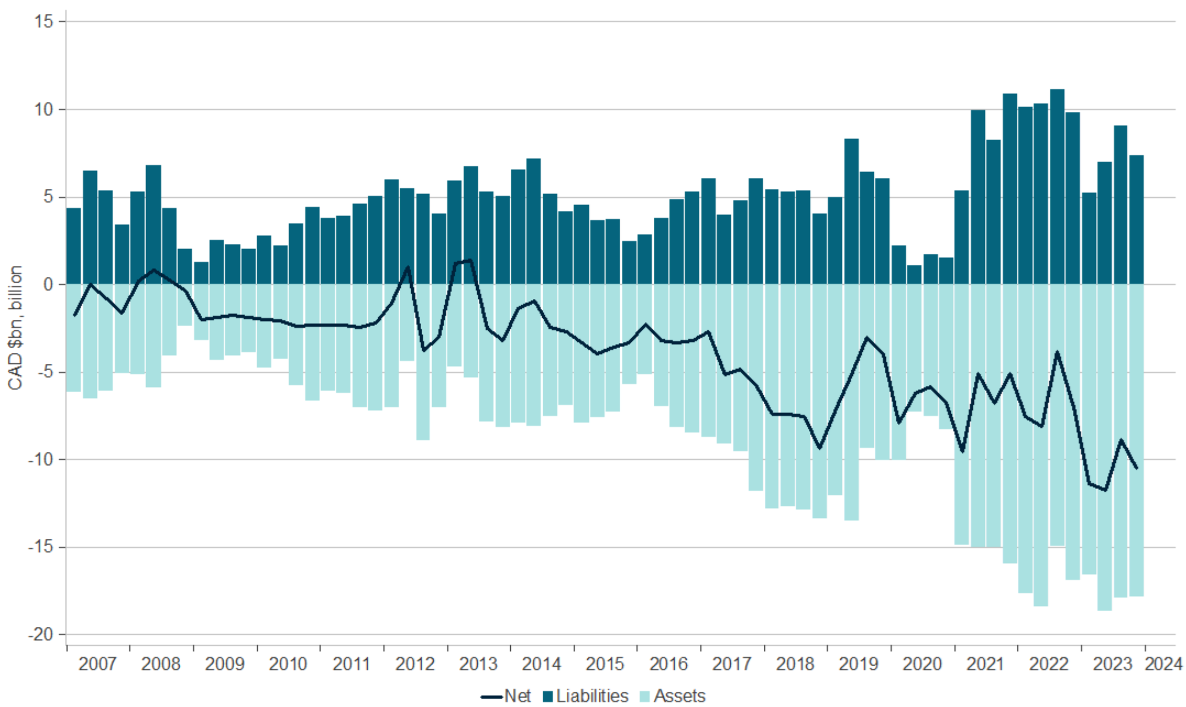
**Exhibit #2: US & UK Retained Earnings Balance**




Source: Macrobond, BNY Mellon

Canada is in a similar predicament to the UK economically, i.e., stagflation fears reign, plus additional sensitivity to US growth. There has been a clear increase in retained earnings overseas since 2021, much of it likely due to US exposures. In fairness, there has been a material lift in retained earnings in Canada as well over the same period as Bank of Canada rates are by no means low. Yet, the balance continues to trend in favour of outflows.

**Exhibit #3: Canada FDI Retained Earnings Balance**

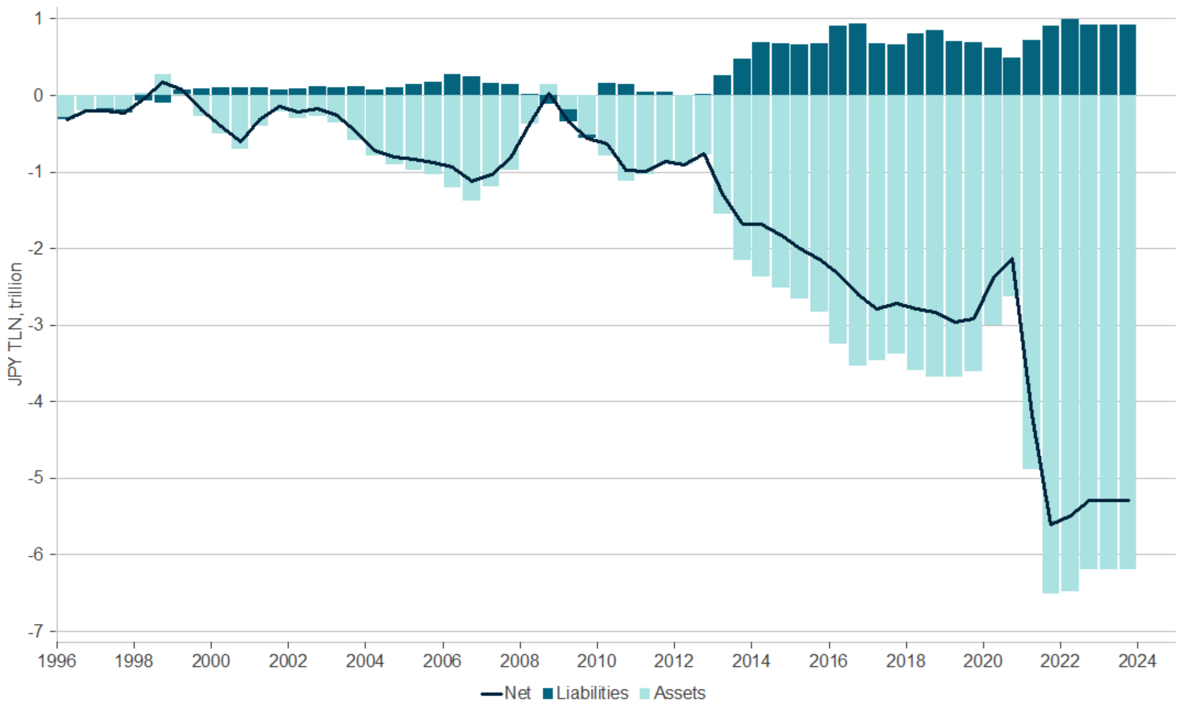



Source: Macrobond, BNY Mellon

Perhaps the best example of retained earnings' sensitivity to interest rates is Japan, where a material rate gap vs. other countries has been in place on a structural basis – and has only widened in recent years. Outflows from Japanese corporates have increased sharply since the prospect of global tightening began in 2021 (exhibit #4), on top of what was an already-accelerating trend since 2012. Meanwhile, a weaker JPY and zero-interest-rate policy has heavily limited retained earnings held in JPY. It was only during the 2008-2009 financial crisis (dynamics changed to some extent) when Japanese corporates repatriated overseas profits on an outright basis, but foreign corporates did the same despite JPY strength.

When rate differentials are highly divergent, barring an extremely strong economic case, it is difficult to justify keeping funds in low-yielding jurisdictions. After all, low yields portend high savings and weak structural growth – never a strong investment case to begin with. We think the ECB should not be reading reverse Yankee issuance as a second wind for Eurozone credit, rather more likely as Eurozone savers now financing US growth in larger amounts.

### Exhibit #4: Japan FDI Retained Earnings Balance




Source: Macorbond, BNY Mellon

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