

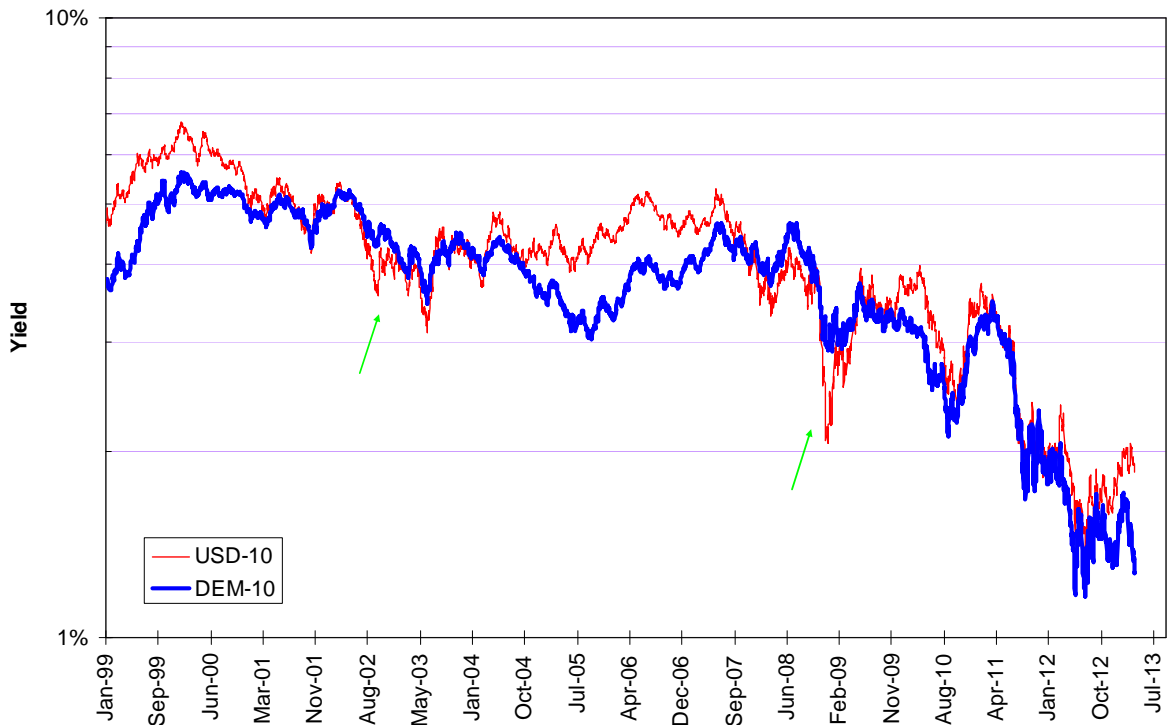
U.S. – German Bond Spread

American ten-year Treasury note yields have exceeded those of their German counterparts for much of the post-January 1999 history of the euro. Two notable exceptions occurred during the equity bear markets of 2001-2002 and 2008-2009, highlighted with arrows in the chart below; in both cases a flight into U.S. Treasuries pushed American yields below German yields. However, once European sovereign debt problems began to emerge in October 2009, the two yields began to converge and then tended to track each other closely throughout the never-ending European sovereign credit saga of 2011, only for U.S. yields to rise above German yields as QE3 began in September 2012.

One of the reasons for the bear-market relative declines in Treasuries was the Federal Reserve's dual mandate of preserving price stability and promoting full employment. Prior to late 2011, the European Central Bank adhered to its single mandate of preserving price stability and therefore did not drive short-term interest rates lower as the Federal Reserve did. Or could: The Federal Reserve could and did buy Treasury and mortgage-backed securities in prodigious quantities, but the ECB had no single Eurozone-wide bond on which to operate.

The Federal Reserve's ability to flood the American banking system with cheap money and risk inflation had the opposite effect on relative long-term yields during bull markets as it was seen as creating a long-term inflationary bias and therefore higher yields. The ECB cannot duplicate this action, nor can it engage in the policies of quantitative easing employed over the past decade by the U.S., Japan, the U.K. and Switzerland. The trade of buying U.S. Treasuries and selling German Bunds during a bear market and reversing it for all non-critical periods, subject to currency risk, seemed indicated.

Comparative Nominal Yields: U.S. And German Ten-Year Notes



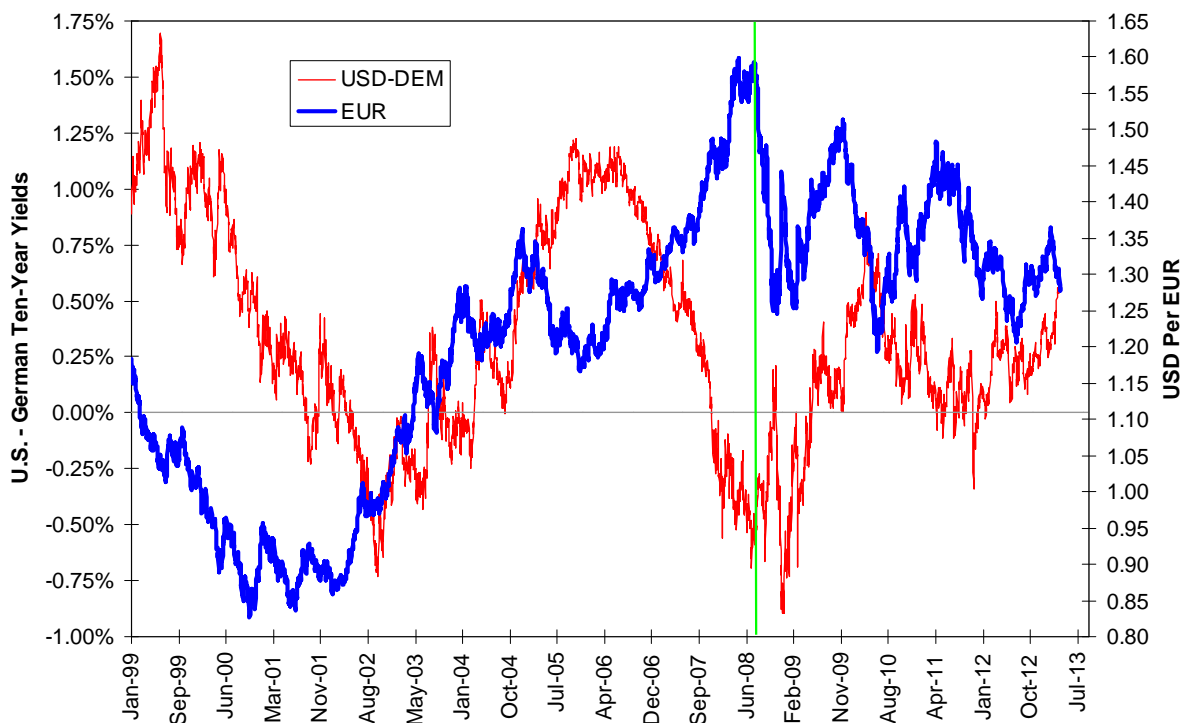
The Currency Link

The various sovereign debt problems of the Eurozone had a highly deflationary effect as the dodgy debt sitting on the books of Europe's commercial banks impaired their ability to turn the monetary base into credit. They also had the effect of an intra-Eurozone flight-to-quality as worried investors shed the debt of weaker credits such as Greece, Portugal, Italy and Ireland and bought stronger bonds such as those of Germany, Finland and the Netherlands.

The sovereign debt situation ended the May 2002 - April 2008 bull market in the euro and raised the very real prospect the currency union would fray. This fear contributed to the wide and erratic trading range of the euro after

April 2008 during a time when the dollar should have continued weakening. The net effect on comparative bond returns is telling. A euro-domiciled investor in Bunds between the October 2009 onset of the sovereign credit problems in the Eurozone and the July 2012 “whatever it takes” pledge by the European Central Bank to defend the euro would have earned a 27.9% total return in euro terms but only a 4.87% return in USD terms.

The Euro And The Ten-Year Yield Spread



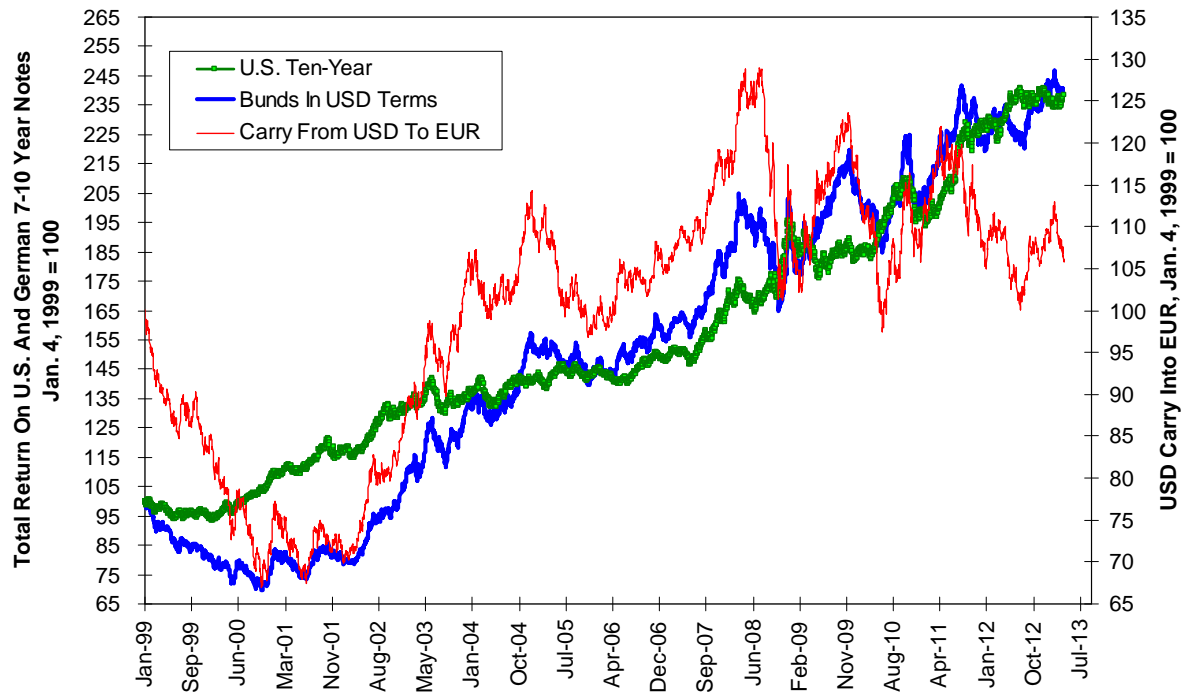
The chart above is or should be very instructive for another reason, the near-total absence of a relationship between the currency’s spot rate and relative long-term bond yields. There are times when the two measures move in parallel and times when they move in opposite, but the currency rate itself is not determinative of the long-term yield spread.

Carry And Comparative Total Returns

How, then, can a bond manager decide how to hedge currency risk, if at all, and how can this decision be managed dynamically? Let’s stipulate many bond managers long ago decided currency hedging was a fool’s errand at best as the interest rate spreads involved in the decision could more than offset the returns on the bond portfolio. If investors want to own bonds in a different currency, that is their decision and the manager should not counteract it with a currency hedge.

However, a long-term spread trader can focus on short-term carry trade to provide direction. While it is second nature to currency traders, bond traders often forget you are not “buying the euro;” no, you are borrowing the dollar and lending the euro. The total return on this trade has an interest rate spread component and a currency spot rate component. While the interest rate spread can dominate the carry trade between, say, the U.S. and an emerging market currency such as the Turkish lira, the carry trade between the dollar and the euro tends to be dominated by the spot rate itself. If you look at the red carry return line below, you will recognize it as a variation on the euro itself.

U.S. And German Total Returns And The Dollar Carry Trade Into The Euro



If we index the total returns on U.S. and German 7-10 year bonds, both expressed in USD terms, and map them against this currency carry return, we find the Bunds' return in dollars, what you as a U.S. investor would receive, is linked rather closely to the short-term carry trade. Thus the decision whether to hedge can be brought down to a very simple trend-following model for the euro:

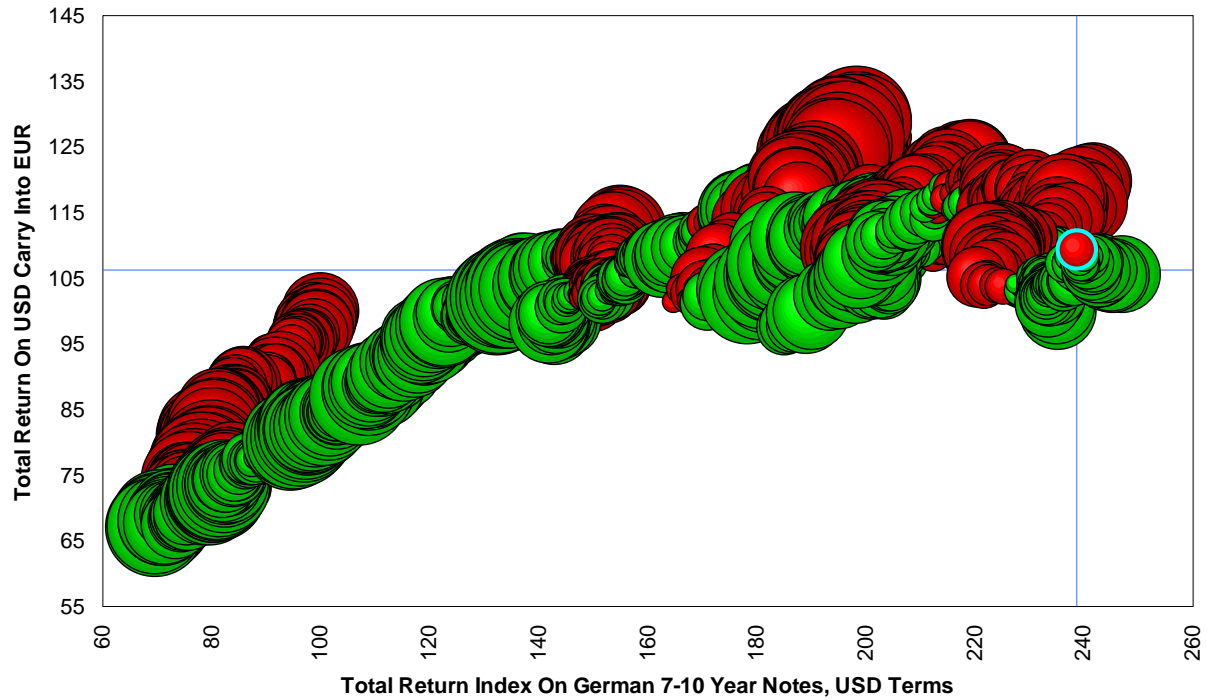
- If equities are not in a bear market, buy Bunds and sell Treasuries
 - Go short the euro if you recognize a downtrend
- If equities are in a bear market, sell Bunds and buy Treasuries
 - Go long the euro if you recognize an uptrend

We might add with a wry smile this is a do-it-yourself “currency overlay” system for which some white-shoe folks earn a lot of money peddling. You can duplicate most of it with a chart and a Technical Analysis 101 rule.

Prospective Returns

We can employ another way of assessing the decision of whether to be long or short Bunds relative to Treasuries and that is mapping the three month-ahead relative performance of Bunds against Treasuries as a function of the short-term carry from the dollar into the euro and the total return on Bunds measured in USD terms. The green bubbles in the chart below represent Bund outperformance; the red bubbles represent Treasury outperformance. The diameter of the bubbles correspond the absolute degree of relative performance. The last datum used, from the end of March 2013, is highlighted with a turquoise ring; the last values available for the three month-ahead calculation are depicted with a blue. This configuration indicates prospective Bund outperformance.

Three-Month Ahead Relative Performance German Vs. American 7-10 Year Notes, USD Terms



The real lesson, however, is just how hard it is for any investor to achieve global diversification. Interest rates, yield curves and currency spot rates form a single system. All too often American investors seek portfolio diversification in non-U.S. bonds only to discover to their surprise they have done nothing other than engage in a circuitous currency trade. It is far better to keep your bond money at home and simply trade the currency.