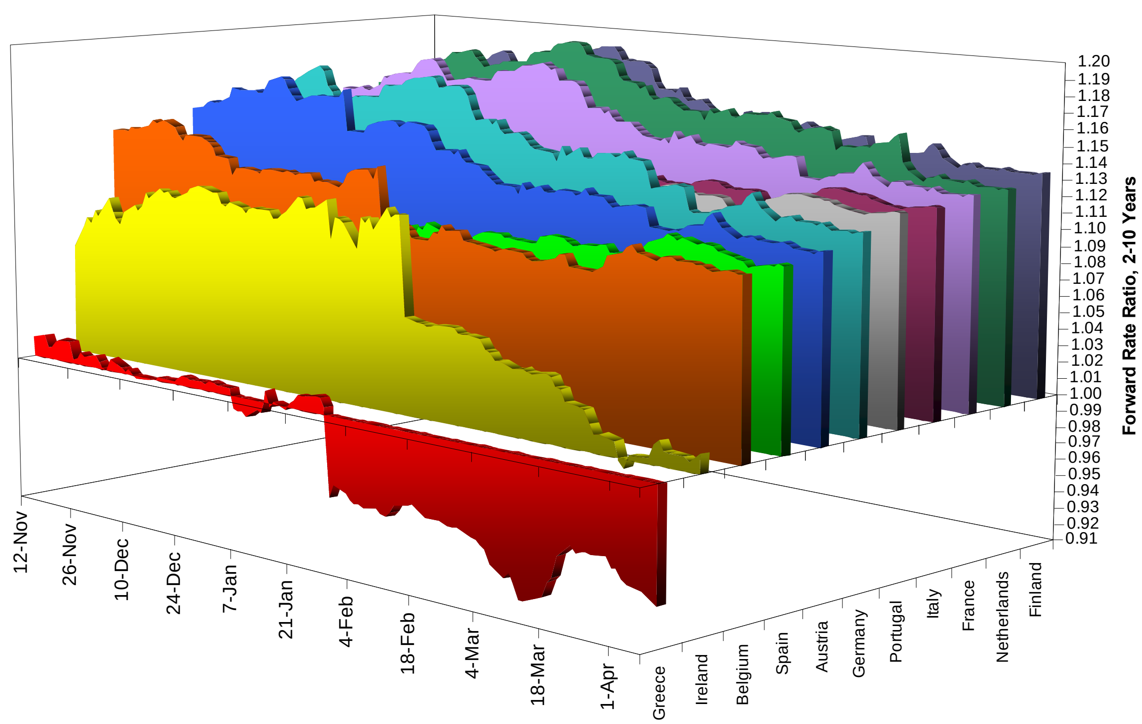
Whatever Happened To Ùber Alles?

Anyone familiar with lifesaving training understands if you go into the water to rescue a drowning person you will be dealing with your worst enemy for several seconds; that person will grab onto anything and you are the solid object of choice.

Germany has to feel its partners in the whole [European project](), especially the already-rescued Greece and Ireland and drowning Portugal, are becoming a bit of a burden to bear. But that is opinion; let's look at some facts in the construct used in [May 2010]() on the interest-rate consequences of the Greek bailout. My conclusion then was the costs of the bailout would be reflected in higher short-term interest rates and a flatter yield curve in the Eurozone's weaker credits and in a steeper yield curve and higher long-term interest rates in the stronger credits with higher short-term interest rate volatility throughout and I cannot believe I just wrote this sentence without hesitating once.

What do we see now as the third bailout inside of a year approaches? First, let's take a look at the changes in various European sovereign yield curves as measured by the forward rate ratios between two and ten years ($FRR_{2,10}$) since the Irish bailout in November. The $FRR_{2,10}$ is the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself. The more this ratio exceeds 1.00, the steeper the yield curve is; values less than 1.00 indicate an inverted yield curve.

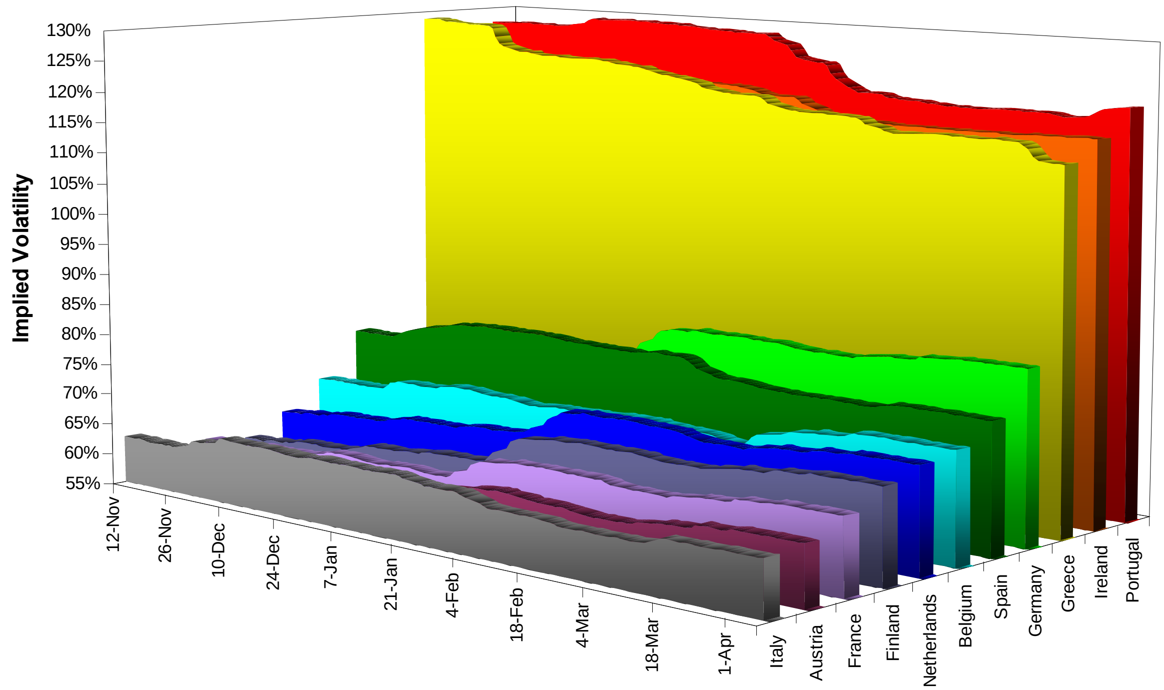
Yield Curves Since November 12, 2010



The Greek yield curve has been inverted for much of this period and the Irish yield curve is flat. In both cases the costs of the bailout are being borne by fiscal austerity. The German yield curve, which used to be amongst the steepest, now is flatter than those of Portugal and Italy, two members of the PIIGS quintet.

What about two-year zero-coupon volatility? Here German volatility is higher than that of Spain, a country whose banking system is a shambles. Portuguese volatility is the highest amongst the group; I expect this to decline if and when the bailout situation is resolved. Both Greek and Irish volatility remains high even though they have declined since November.

Two-Year Zero-Coupon Implied Volatility Since November 12, 2010



Now let's top off the whole deal by noting the euro is poised to move higher, perhaps significantly so. As Japan is pouring liquidity into its banking system and making the world safe once again for the yen carry trade and as the U.S. is debating with itself whether to stop printing money, the European Central Bank is tightening credit. Money must flow toward its greatest return, and that will be found in the euro unless some external agent, such as China, decides to start buying dollar assets in ever-greater quantities to avoid currency disruption.

If the PIIGS have struggled with the strong euro to-date and if German exporters have welcomed a euro weaker than what the old Deutsche mark might have been, what will the financial stress in the Eurozone be with a stronger currency? The answer is simple: Higher.