

U.S.-German Long-Term Bond Spreads

There is little question the dollar and the euro have been winning the ugly dog contest with each other for the better part of four years now. The real upshot, or downshot if you prefer, has been a nascent move by other countries to diversify their reserves away from the dollar has encountered resistance. As much as the dollar has been abused by Uncle Sam, it has a good chance of being here ten years from now and not fragmenting back to the separate currencies used in the Articles of Confederation era.

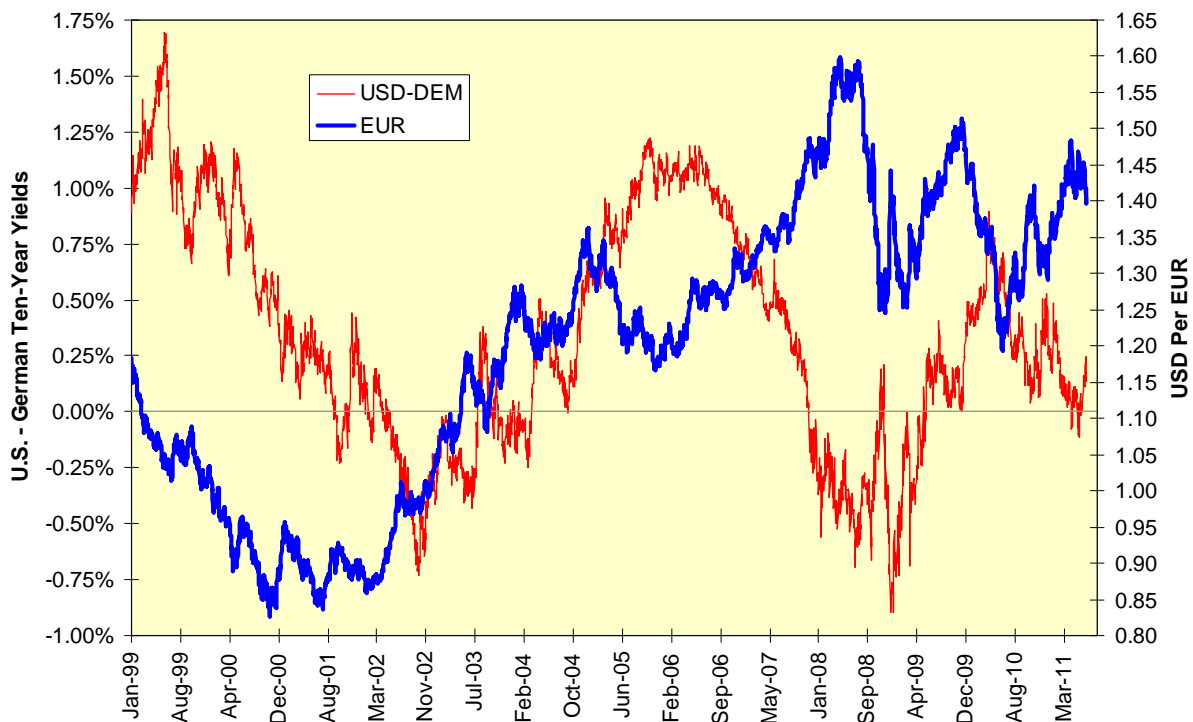
Paradoxically, the dollar's continued and prospective dominance at the center of the global monetary system will contribute to its long-term decline; we will continue to abuse the privilege of having the reserve currency by continuing to print our way out of problems.

Long End Of The Yield Curve

While currency movements tend to be dominated by expected short-term interest rate differentials and prospective asset returns, we should keep the role of currency movements in establishing long-term rate differentials in mind. After all, capital markets depend more on these long-term rates even though monetary policy is fixated on the overnight rate.

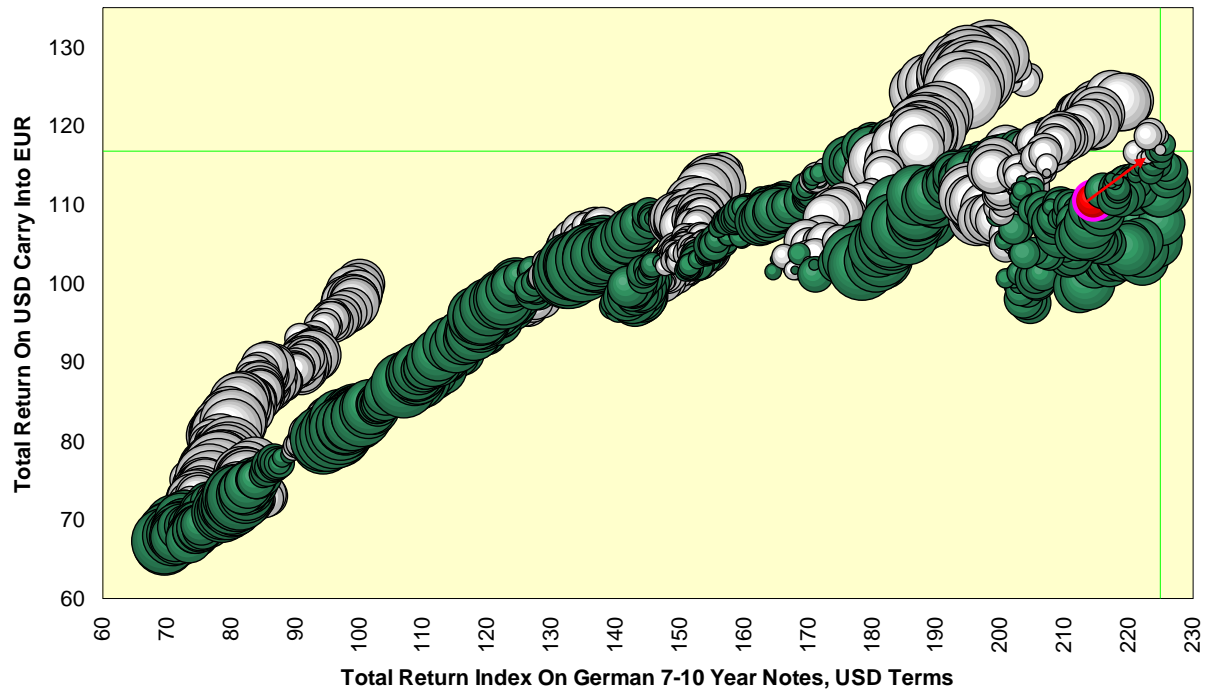
The yield spread between ten-year Treasuries and Bunds has been moving directly as a function of the euro over the past six years; as the dollar strengthens, Treasury rates rise relative to Bund rates and vice-versa. At present, the euro looks uglier than the dollar despite our promises to print more of them and Treasury rates are rising.

The Euro And The Ten-Year Yield Spread



We can look at this prospectively as well. If we map the relative total returns of 7-10 year Bunds vis-à-vis 7-10 year Treasuries as a function of the total return in USD terms on 7-10 year Bunds and the excess carry return on borrowing the USD and lending the EUR, a very clear pattern emerges. The dark green bubbles depict Bund outperformance; the white bubbles Treasury outperformance with the diameter of the bubble corresponding to the absolute magnitude of the difference. The current environment is marked with a green bombsight and the datum from three months ago is highlighted in red.

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



If the dollar strengthens, Bunds will outperform; if the dollar weakens, Treasuries will outperform. As the bias will be for the euro to strengthen from here if and when the Eurozone can stop losing a member per day in the Chasm of Doom, we should expect Treasuries to outperform Bunds over the next three months.

The other major message is international bond diversification, at least across the Atlantic, is nothing other than a currency trade in disguise. You might as well either trade currencies or one of those long/short euro ETFs that have sprouted like dandelions across the financial landscape.