Eurozone Fixed-Income Stresses Worsen

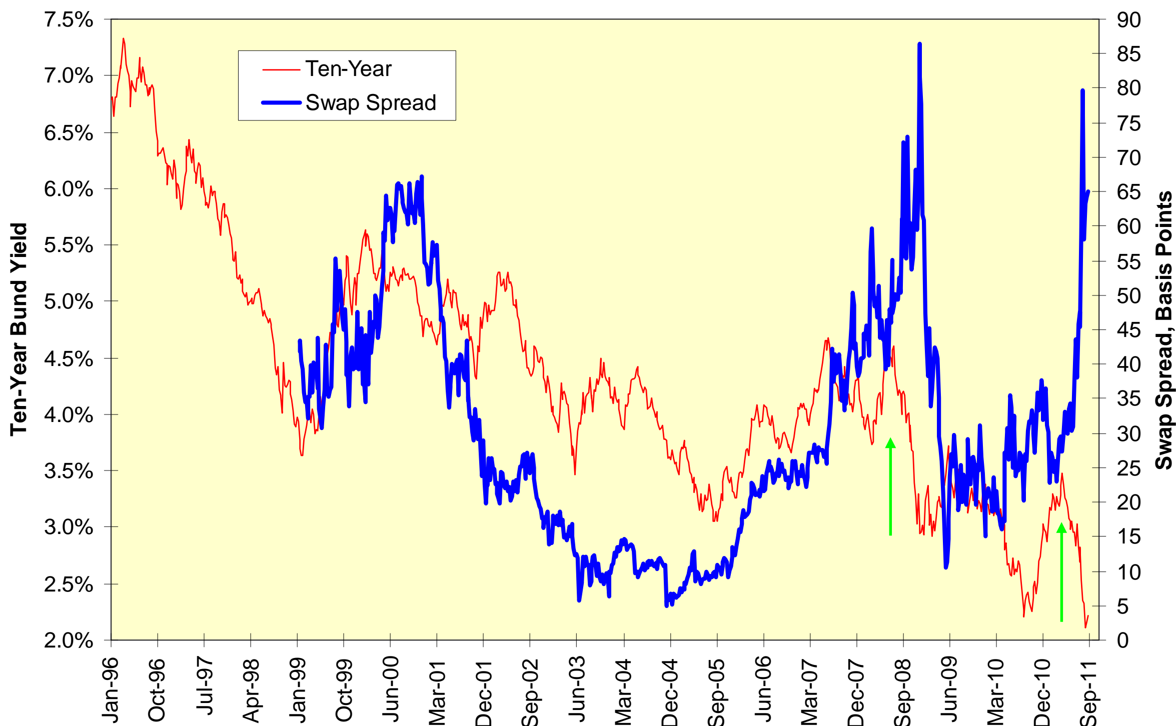
Generals fight the last war and investors remember their last bear market. It takes time to forget; the U.S. remained chastened by Vietnam until its easy victory in the Persian Gulf War and then promptly got itself into not one but two interminable and unwinnable wars in Iraq and Afghanistan. Investors forget the horrendous dotcom bear market quickly enough to fall for another credit bubble and then had to endure an even more horrendous credit debacle in 2008-2009.

To review the bidding, American politicians did not repeat the Vietnam experience for a generation; investors overdosed on the same monetary heroin twice in a decade. Let's hope this does not mean politicians are smarter than investors.

In Some Ways Worse

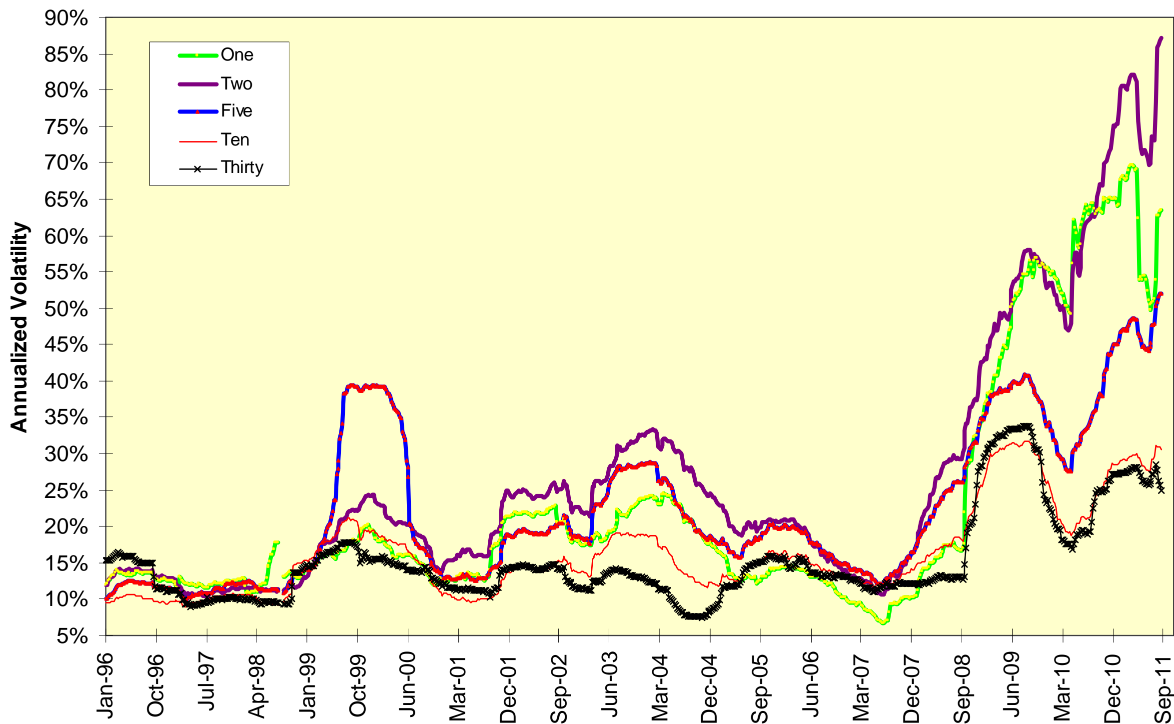
If we cast our eyes across the pond to Europe and its hoot of a pretension it is all one great big happy family we see some alarming indicators in the fixed-income markets. Let's take two of them. The first is the relationship between ten-year Bund yields (Germans call bonds Bunds; Spaniards call them Bonos. They are so sophisticated) and ten-year swap spreads. As noted yesterday, a swap spread is the payment a floating-rate borrower is willing to make to fix the loan's rate. The higher the swap spread, the more the market believes the present interest rate is too low.

Bund Yields And Swap Spreads Looking Like 2008



What we see above is the present situation is in fact similar to 2008, as marked with the green arrows: Bund yields have been plunging as risk-averse investors seek shelter in a storm, and swap spreads are surging as floating-rate borrowers scramble to fix their payments. None of this occurs in a healthy financial and economic environment.

Another indicator flashing red is the term structure of zero-coupon implied volatility. These levels have blown so far past the 2008-2009 higher that those readings look perfectly normal on the chart. The two-year Schatz' (German note) volatility has increased furthest and fastest as the market is convinced the present levels and very steep German yield curve are unstable.



Higher volatility means markets are less liquid and all parties involved have to pay higher costs to fix and hedge their credit commitments. Maybe someone, somewhere, believes paying high insurance costs on two-year money at levels considered untenably low is conducive to economic growth. I do not and have not, and the macroeconomic track record since 2008 supports my skepticism.

Most of the time entrance into a new war prompts people to ask a question along the lines of, “Is this another Vietnam?” We have been asking whether the current markets are another 2008. No; it is different in many ways but it is worse in others. Until these Eurozone credit market stresses are reduced, we are still in trouble.