Germans To Enjoy Funds For Bunds

The Long End of The German Yield Curve Positioned To Gain

I mentioned yesterday how the arrival of *unexpectedly* low short-term interest rates in the Eurozone would be bullish for European stocks and was already bullish for long-term German Bunds. Let's take a look at the mechanics of the German yield curve trade using the same methodology employed in June 2011's Recent Bullish Run in Long-Term Bonds May Be Hitting Short-Term Resistance.

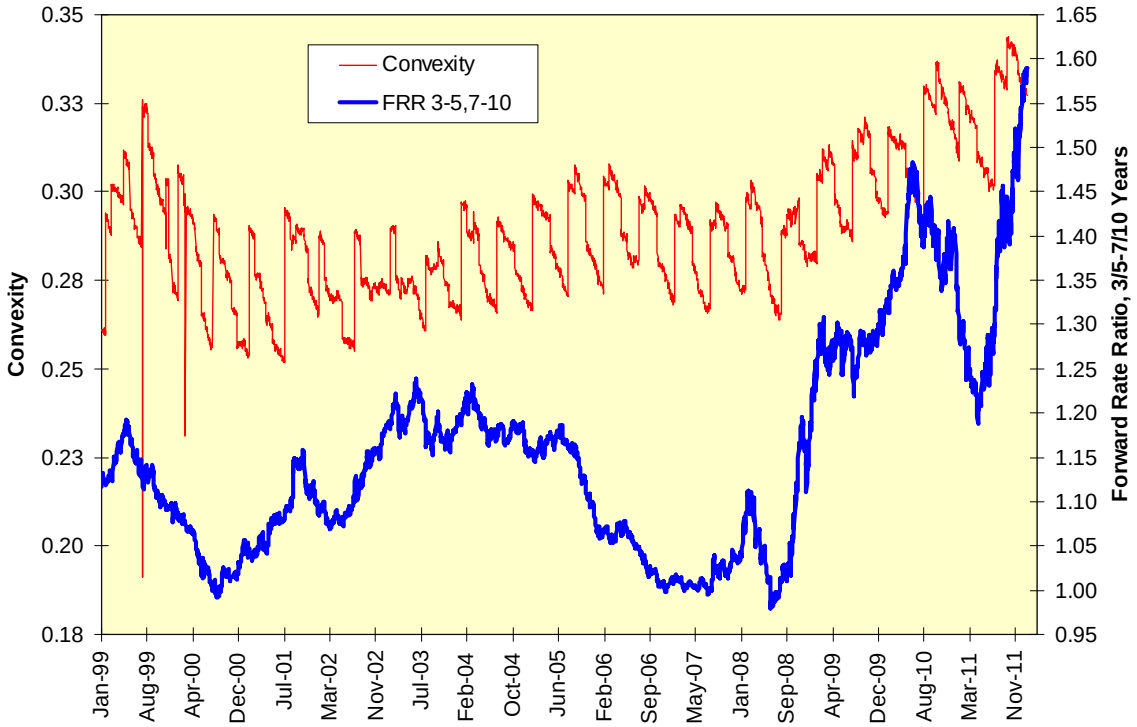
As an aside, timing is everything in this business and my timing in that June 2011 was terrible as the collapse of debt ceiling talks and the Standard & Poor's downgrade of the U.S. along with the Federal Reserve's Operation Twist led to a spectacular run in long-term Treasuries beginning in August 2011. Here is a piece of advice for anyone wishing to be a market commentator: You will be right or wrong only in retrospect; events will demolish carefully constructed analysis. So when you are wrong, admit it and move on; the only thing you can control is your own effort and intellectual honesty.

The Trade Over Time

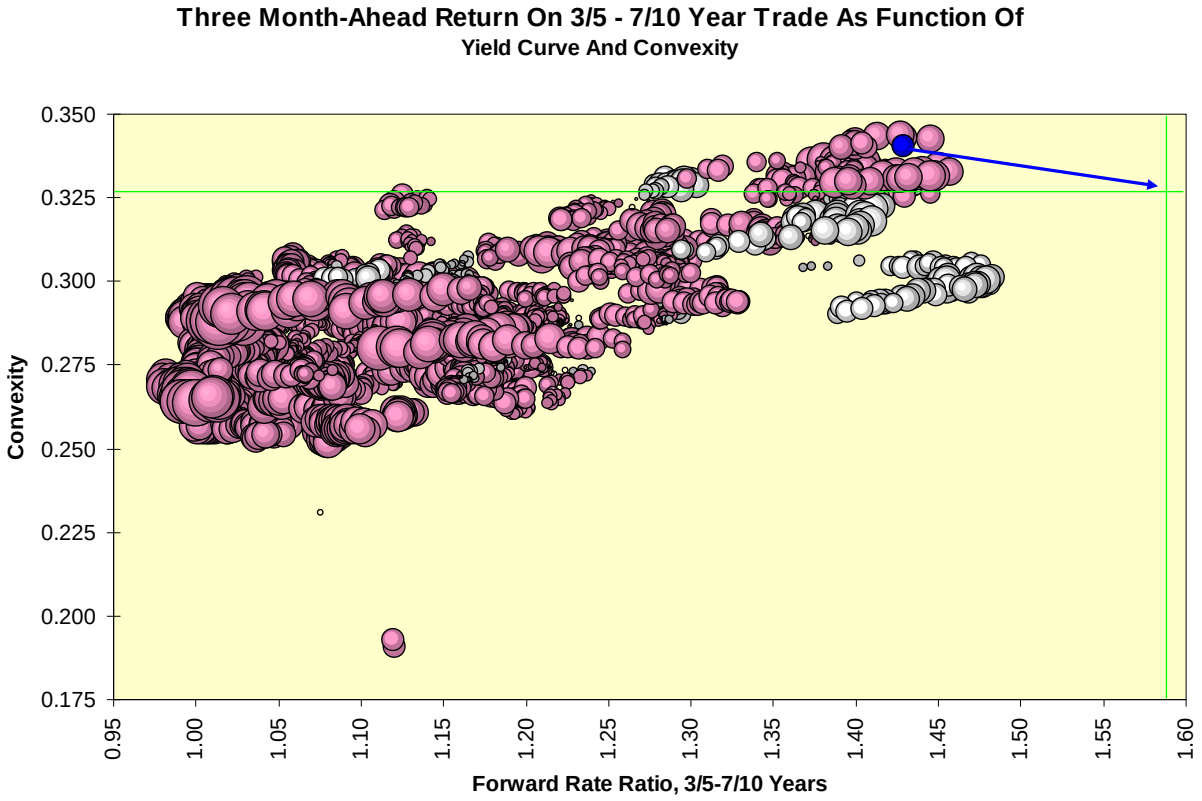
The trade, as before, is a duration-neutral bullish flattener. This involves borrowing 3-5 year Bunds and lending 7-10 year Bunds. The trade is done at a 2.088:1 ratio of shorter-dated to longer-dated Bunds to account for the different durations, or measure of bond risk, involved. The trade results in a pick-up of convexity, or the rate at which duration changes as a function of yields. Convexity is valuable: The higher it is, the more the bond gains as rates fall and the less the bond loses as rates rise. For those of you comfortable with option Greeks, think of duration and convexity as you might delta and gamma.

That is the mechanical "why" of the German yield curve trade. The real reason behind the trade is short-term German interest rates are getting squeezed toward 0% the same way they were in the U.S. If the ECB is going to be more accommodative, investors are going to be forced into longer-dated Bunds. We can see this in effect by mapping the history of the German yield curve as measured by the forward rate ratio between 3-5 and 7-10 year Bunds. The is the forward rate between the two segments, divided by the 7-10 year rate itself; the more it exceeds 1.00, the steeper the yield curve is. The German FRR is the steepest it has been during the euro era. That and the lower level of interest rates are combining to push the net convexity of the trade higher.

Convexity Of Bund Bullish Flattener Versus Yield Curve



If we rearrange the data and map three month-ahead returns on this trade as a function of the yield curve and convexity, we find ourselves in uncharted waters. The pink bubbles below represent positive returns; white bubbles depict negative returns. The absolute diameter of the bubbles corresponds to the magnitude of the return. The last datum used is marked in blue and the present environment is marked with a green bombsight.



While there are no observations anywhere near the present environment, we can extrapolate the previous trends of convexity and yield curve compression to conclude any flattening trade made during such a steep yield curve has an excellent chance of being profitable.