How French Elections Affected German Bunds

The Panic To Buy Germany Exceeded The Panic To Sell France

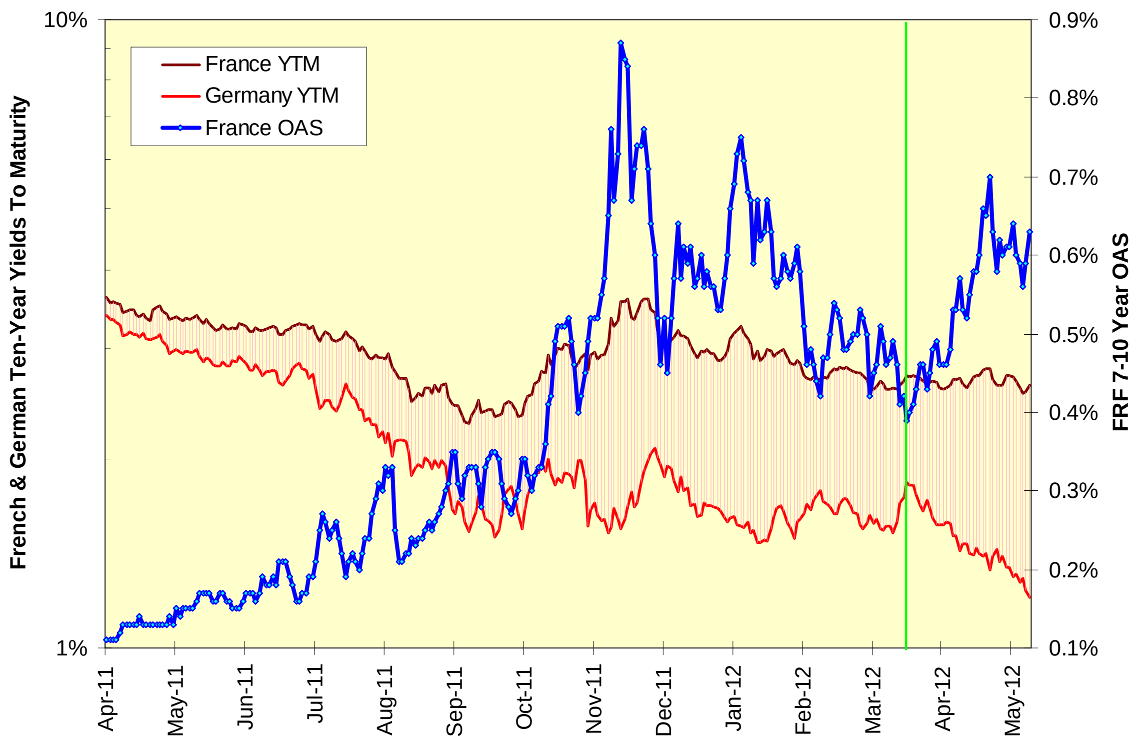
Just as it takes two to tango and the sound of one hand clapping is pretty useless, a spread can widen or narrow via the action of one or even both of its legs. Strangely, many commercial spread traders such as those involved in the soybean crush for firms such as Bunge (BG) or Archer Daniels Midland (ADM) or the crack spread for refiners such as Valero (VLO) seldom focus on the legs at all; they simply view the spread as an entity.

In addition, we are trained to believe that flight-from is a more powerful impulse than flight-to; this perhaps is hard-wired into our brains as fleeing from danger tends to enhance survival. We do not bat an eye when the VIX jumps when the S&P 500 falls as we just assume scared hedgers and those foolish enough to write naked put options or pay the floating leg on a variance swap are acting out of normal self-defense impulses.

Flight To Bunds

What a surprise, then, when an event comes along like the French election where the panic to buy the perceived safer asset, German Bunds, exceeds the panic to sell the perceived riskier asset, French OATs. This is similar to the phenomenon I noted recently with Spanish and Italian bonds in Low Rates Will Create Bad Habits in Germany, Eventually. The key differences are both French and German 7-10 year yields have fallen and the option-adjusted spread for French OATs is well below levels reached in November 2011 and January 2012. Bund yields have declined at a daily slope of 0.966% since March 20, 2012; the corresponding slope for OATs has been 0.029%. This is a buying panic for Bunds.

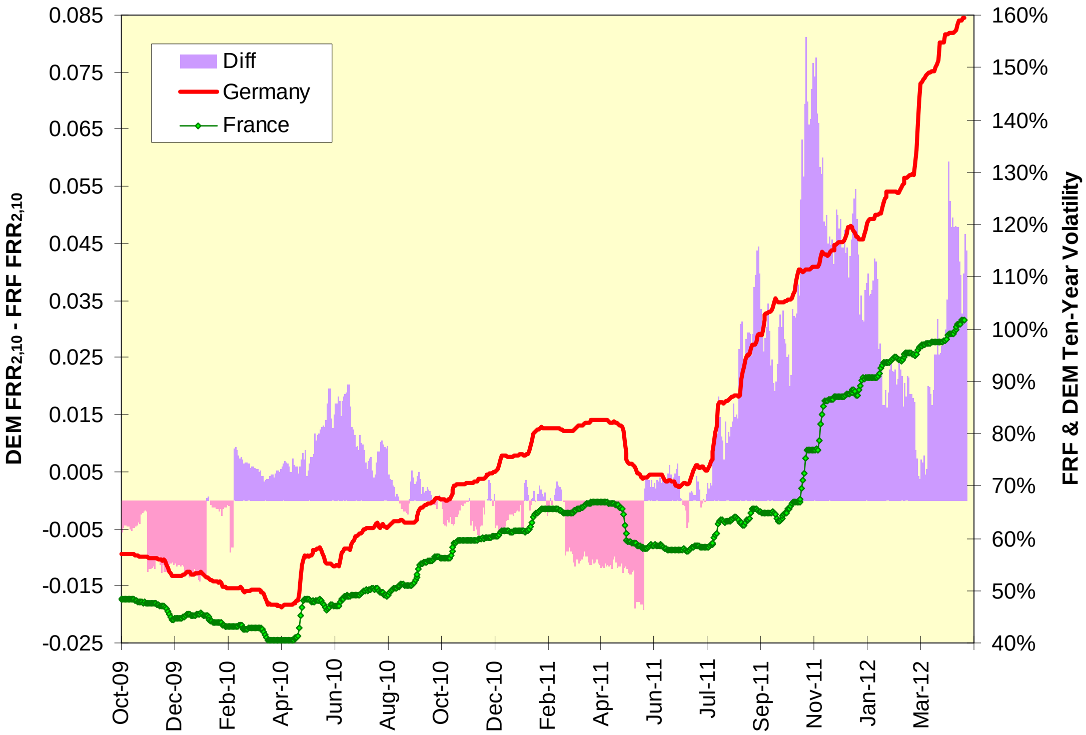
German Yields Falling More Quickly Than French Yields



Upsetting The Apfel Cart

This inflow is destabilizing German markets in a manner parallel to what I noted in Switzerland's Negative Interest Rate Dilemma. Here the instabilities are manifesting themselves in extreme volatility for zero-coupon ten-year Bunds and in a much steeper yield curve. The volatility difference between Germany and France is obvious at roughly 160% versus roughly 102%. The yield curve one is more subtle: If there was a panic to exit France, we would see a flatter French yield curve and the gap between the German and French yield curves would be greater. Instead, the German yield curve has steepened and the French yield curve has remained about the same. It is this extreme move in the German yield curve that is driving volatility higher.

The Flight Into Germany Has Been Destabilizing



What, if anything, should you do? As markets are alleged not to discount the same thing twice, you should assume German Bunds are over-priced. Shorting them will get you nowhere and buying them is pointless at these yields. The best course of action as long as the money is on the eastern side of the Rhine is for you to keep yours on the western side of the Atlantic for now.