Alfred E. Newman's European Vacation

Most of us have developed ingenious and sometimes productive methods of procrastination, such as cleaning out the garage and even organizing the garden tools in alphabetical order when we are supposed to be doing the taxes. But what happens when an entire market decides in its collective wisdom to ignore the 800-pound gorilla waltzing about the room while obsessing over a fluttering moth?

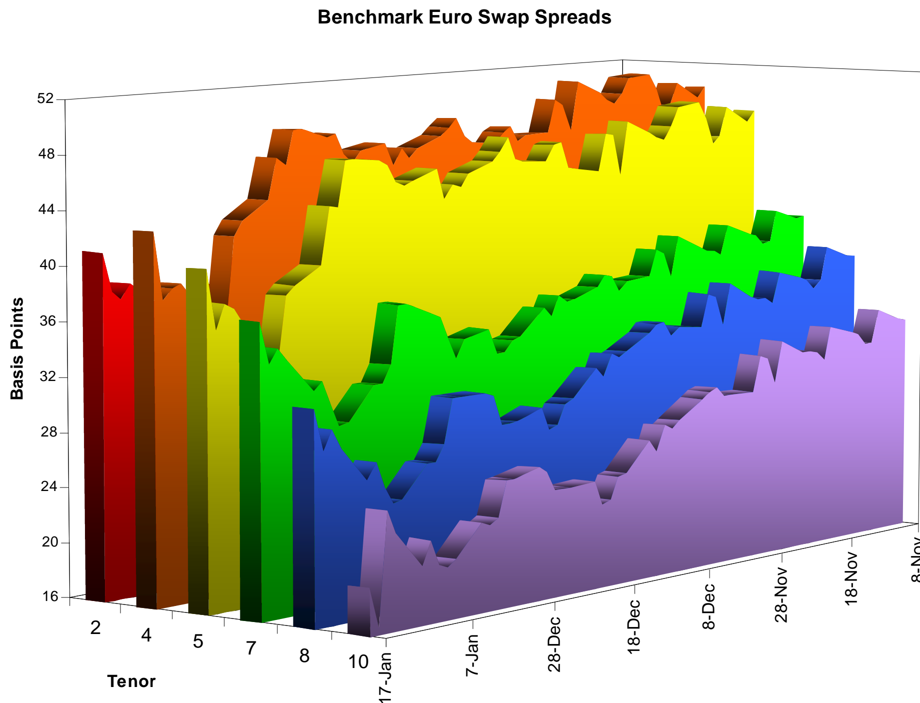
This is happening in the world of swap spreads in the Eurozone, a fancy name for those parts of the European Union who thought it wise to give up drachmas and lira to reap the many benefits of the common currency including a regional average unemployment rate of 11.8% and youth unemployment rates so high in certain countries as to be meaningless. In regards to the last statement, whenever you see unemployment rates on the order of 40-50%, you probably are looking at an underground economy wherein barter has replaced detectable and taxable activity.

The Inverted Swap Spread Market

Benchmark interest rates in the Eurozone hit negative levels during last year's iteration of the rolling sovereign debt crisis, not to be confused with the crises of 2010, 2011 or whatever the fates have in store for us in 2013. You still can pay 0.078% to lend money to Germany for one month and they will let you lend them money for free for a three-month period. Nominal ten-year Bund yields are just under 1.61% at the time of this writing, and with a harmonized CPI of 2.0%, that works out to a real yield of -39 basis points.

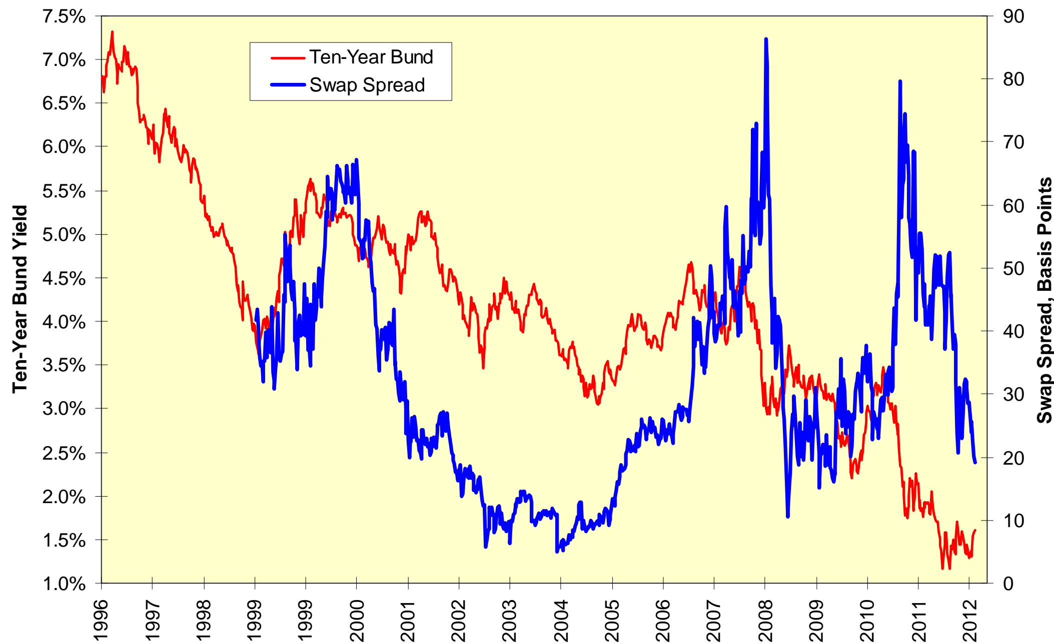
So what are our various *freunden*, *amigos* and *φιλους* worried about these days? As evidenced by the swap spread market, they are not worried about a rise in long-term interest rates so much as they are about a rise in short-term interest rates. The higher a swap spread moves, the more willing a floating-rate payor is to fix rates; think of it as insurance against floating rates moving higher.

The chart below shows a strong inversion in the term structure of swap spreads. Not only are shorter-dated spreads higher than longer-dated ones, but they moved higher more quickly when Mario Draghi announced recently he was not looking to become more stimulative.



Ten Years After

Now let's take a look a ten-year Bund yields mapped against ten-year swap spreads. Yields have been rising since late July, right when the aforementioned Draghi pledged to do "whatever it takes" to save the euro. They are now 0.44% higher, a considerable jump off of a 1.167% starting point. Ten-year swap spreads have plunged from 52 to 19 basis points on the notion "whatever it takes" will involved printing sufficient euros to keep sovereign yields low.



What would happen to the price of those ten-year Bunds if yields crept back up to even the August 2010 pre-Jackson Hole level of 2.2%? The on-the-run Bund is priced now at 99.02 at a 1.607% yield. At 2.20%, the price falls to 93.73. That is a 5.34% loss; it also wipes out about 3.5 years of coupon income.

The risk/reward of such a trade is poor. Markets do not sell off when people are expecting them to sell off, they sell off when no one is insuring against the adverse event and the continuation of unrealistic pricing depends on government and central bank policies capable of changing instantly and without warning. Bund-based ETFs such as Pimco's Germany Bond index (BUND) have had a nice run, but with yields so low and the euro having rebounded strongly already, why be a *schweinhund*?