Weaker Eurozone Credits Benefited From Their Problems

I entitled a column one year ago "Low Rates Will Create Bad Habits In Germany, Eventually" and concluded:

> "I think this process will happen in Germany if low rates persist. Everyone likes to pretend they are virtuous until the freebies are passed about; then we find out how few aesthetes really exist. Just as absolute power corrupts absolutely, free money destroys prudence."

Germany has been extending its balance sheet, with the occasional pushback on projects such as rescuing large Russian deposits in Cypriot banks. Angela Merkel felt more comfortable clipping small Cypriot savers than in ending the circular game of European commercial banks and sovereign states lending each other money neither party really has.

Much of the kerfuffle surrounding the bungled affair was based on fear the procedure used for Cyprus would be used for Spain and Italy. Well, just as in the case of office project management we have progressed from a search for the guilty to the punishment of the innocent, followed by praise and honors for non-participants. In this instance, it means both French and Spanish 7-10 year bonds have outperformed German 7-10 year Bunds since the February 1, 2013 local maximum in the euro and the beginning of the present Eurozone sovereign debt rally. Italian 7-10 year bonds have underperformed their German counterparts, but have gained in absolute terms nevertheless.

Let's assume, in the face of overwhelming evidence to the contrary, fixed-income investors have not taken total leave of their senses; after all, this is the same crowd piling into negative real yield Treasury debt in the U.S. Are they applauding the Hollande government in France, the never-ending dysfunction in Italy or runaway unemployment in Spain?

Other Peoples' (Printed) Money

No, they are once again fleeing to the printing press. As the European Central Bank cannot engage in quantitative easing directly, Eurozone governments effectively have had to import U.S. and Japanese printed money. The carry return from borrowing the yen and lending the euro has been 26.51% since the yen's November 2012 downside breakout and 3.82% since Japan's acceleration of QE was announced in early April. If you are going to buy government bonds, still rated highly by all of those Basel accords and other risk-management fictions, you might as well be a yield-hog and go for the highest-yielding ones out there. If the whole thing blows up, it would have blown up anyway had you been holding Bunds and, hey, you would not have made your quarter by shipping money off to Frankfurt anyway.

I was playing around with the Google translator from Japanese to Italian, looking for a phrase for "gimme some of those," but it did not recognize my awkward Kyushu dialect.

The whole situation is so deliciously circular: The very wayward and profligate governments who managed to borrow their way into a whole prompted the creation of global policies whose net effect has been to lower the cost of debt service for those very same governments. It has rewarded American investors as well. The total returns on Italian, Spanish and French 7-10 year bonds since the November 2012 downside breakout in the yen in USD terms have been 10.88%, 17.42% and 5.96%, respectively. For German and U.S. 7-10 year bonds, the returns in USD terms were 4.26% and 4.25%.

Were you rewarded for risk or were you rewarded for someone providing you with a backstop on lower-quality bonds? The end result is the same, but I am going to go with the latter.