Bunds Should Outperform Treasuries

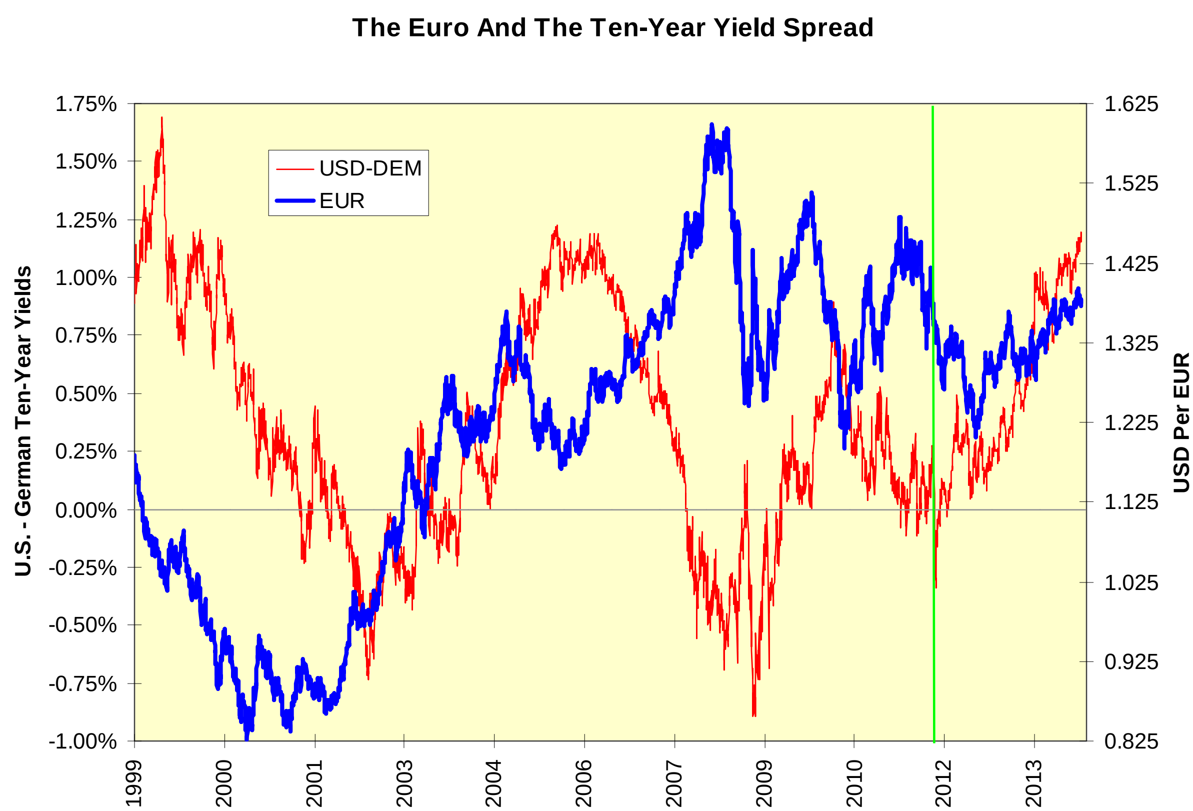
Back in the days when foreign ministers were a hard-bitten, *realpolitik*-infused lot of scallywags (Ever met a card-carrying scallywag? Me neither) Lord Palmerston uncorked this quotation for the ages: "Nations have no permanent friends or allies, they only have permanent interests."

This holds true for secular market trends as well. A large number of American investors have convinced themselves we are entering a new age of tighter credit conditions simply because the Federal Reserve will be expanding its balance sheet at a slower rate. However, nations collectively have the permanent interest of maintaining high levels of global liquidity; I noted last month China could offset tapering by purchasing euro-denominated assets. Those funds then could be swapped for dollar-denominated assets. It had the added advantage of doing for the Eurozone what the European Central Bank was unable to do, and that was execute a European version of QE even though they are starting to contemplate ways to do that right now.

The prospective action in the Eurozone is consistent with another one of those permanent interests all nations seem to have these days in keeping their currencies relatively weak. This is an odd game as the reductio ad absurdum is everyone's currency becomes worthless at the conclusion if played successfully.

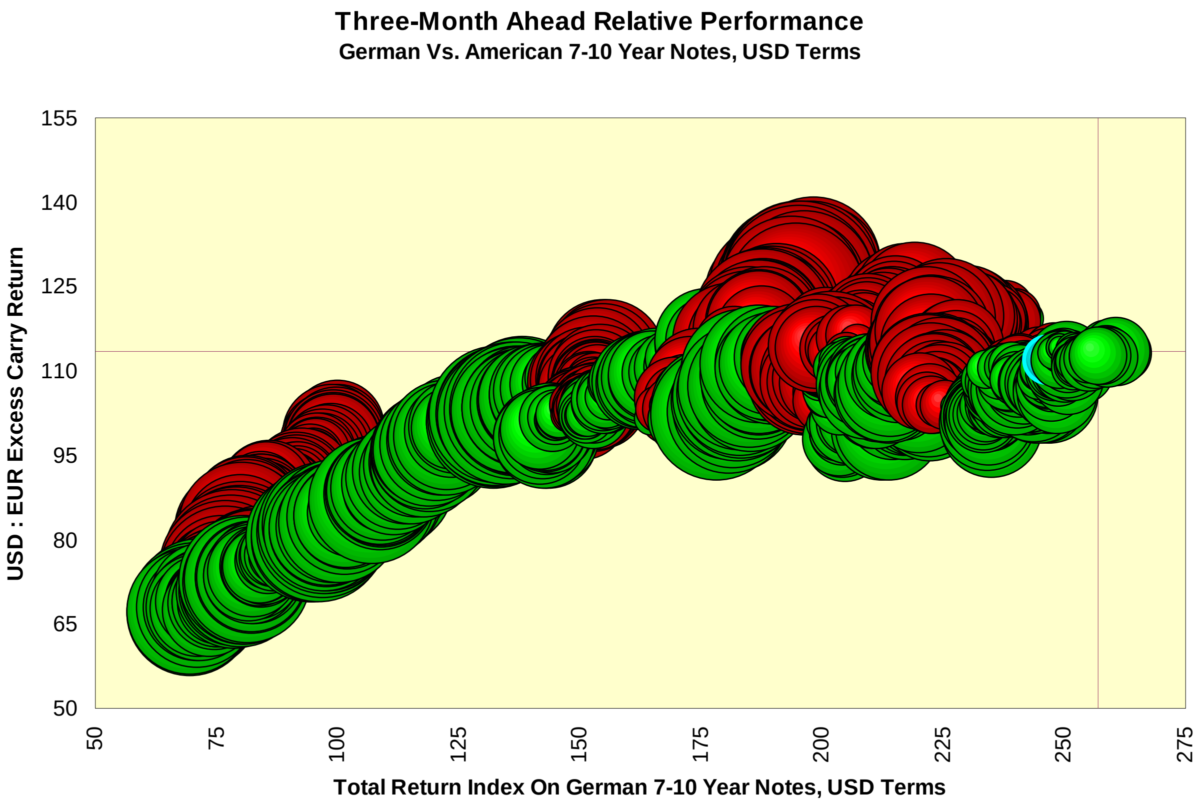
Relative Bund Performance

Bunds have returned 2.53% and 2.75% in EUR and USD terms, respectively, since the mid-January peak in the Chinese yuan. This compares most favorably with the 0.84% total return for 7-10 year Treasuries. This strong relative performance has been building since the November 2011 expansion of global currency swap lines. The yield gap between U.S. and German ten-year notes has been expanding for almost two and one-half years.



The euro, interestingly enough, did not start its gradual move higher until the end of July 2012 when Mario Draghi's "whatever it takes" declaration removed much of the common currency's existential risk.

Now if we map the prospective relative returns for Bunds vis-à-vis Treasuries as a function of the Bund returns in USD terms and the excess carry return from the dollar into the euro, a clear pattern emerges. The green bubbles at the present environment, marked with a bombsight, indicate Bund outperformance. The red bubbles are zones of Treasury outperformance.



We would need to see a stronger euro and lower returns for Bunds in USD terms to push Treasuries into a zone of outperformance. This is unlikely given efforts to push the euro lower and continued external flows into Eurozone sovereign debt.

The Pimco Germany Bond Index ETf (BUND) has captured much of this move well and should continue to do so.