

Bunds Really Are Return-Free Risk

It is easy to forget with all of this week's hand-wringing, knuckle-cracking and other actions with various and sundry appendages about last week's gift to the markets from the European Central Bank. Their move to lower deposit rates to only -30 basis points instead of the expected -40 led to some big gains in the euro, large losses in European stocks and bonds and, par for the course, large hedge fund losses.

Those sharp moves masked one of the real problems associated with quantitative easing, one that has manifested itself for several years in Japan as well. In homage to Margaret Thatcher's observation the problem with socialism is sooner or later you run out of other peoples' money, in QE you sooner or later run out of sovereign debt. Parliaments, congresses and other governing bodies hesitate to expand deficits to issue more debt for fear the populace will react badly and investors find themselves wondering why they thought paying to lend money to profligate governments was a good idea.

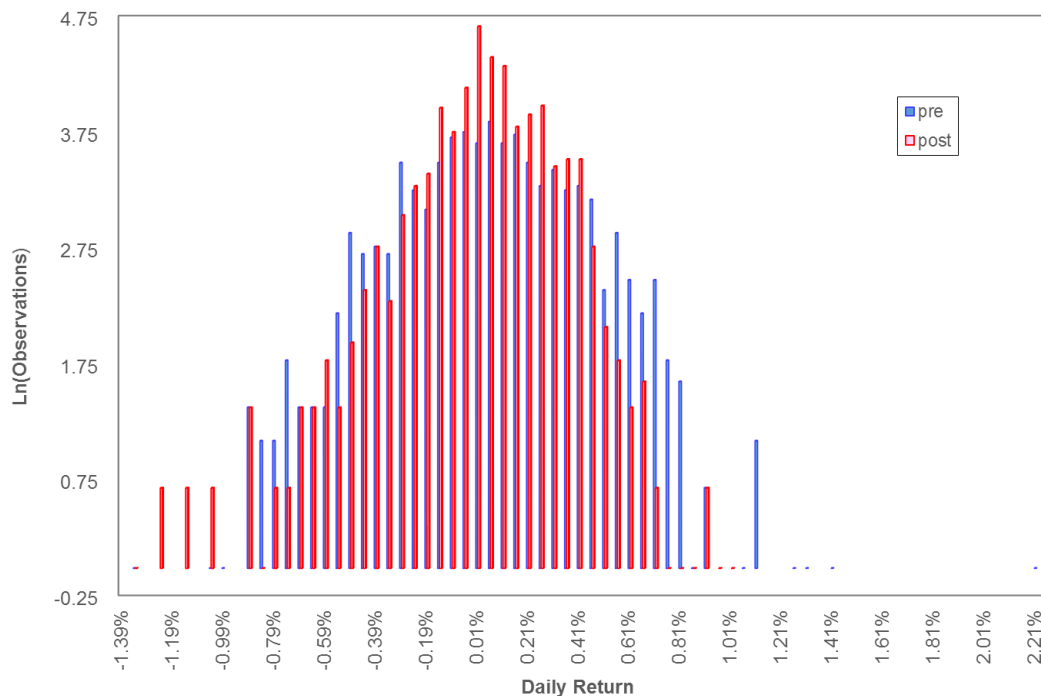
The end result is Bunds turn into instruments with very limited gain and relatively open-ended losses. The German verb for "to decorate," *schmucken*, yields a conjugate very descriptive for lenders in this market. The profit profile of this trade is that of a short put option. Go ahead and write a few of these on the S&P 500 if you have a hankering for losing a lot of money in a hurry.

Distribution Of Returns

The large selloff in Eurozone bonds on December 3, 2015 underscored this problem of euro-denominated sovereign debt during the "whatever it takes" era starting in July 2012. Let's compare the distribution of 7-10 year Bund returns between the October 2009 onset of the Eurozone sovereign debt crisis to July 2012 to the distribution from July 2012 onwards.

The two return sets are different at a 78.61% confidence level. More critically, the skew of returns shifted from a slightly positive 0.23 to a strongly negative -0.73 and the kurtosis shifted from a slightly peaked 1.65 to a strongly peaked 2.67. Bund returns have clustered near their post-July 2012 average of 0.013%, kept there by strong monetary accommodation, but have sold off sharply whenever that accommodation has been threatened.

Distribution Of 7-10 Year Bund Returns Changed After July 2012

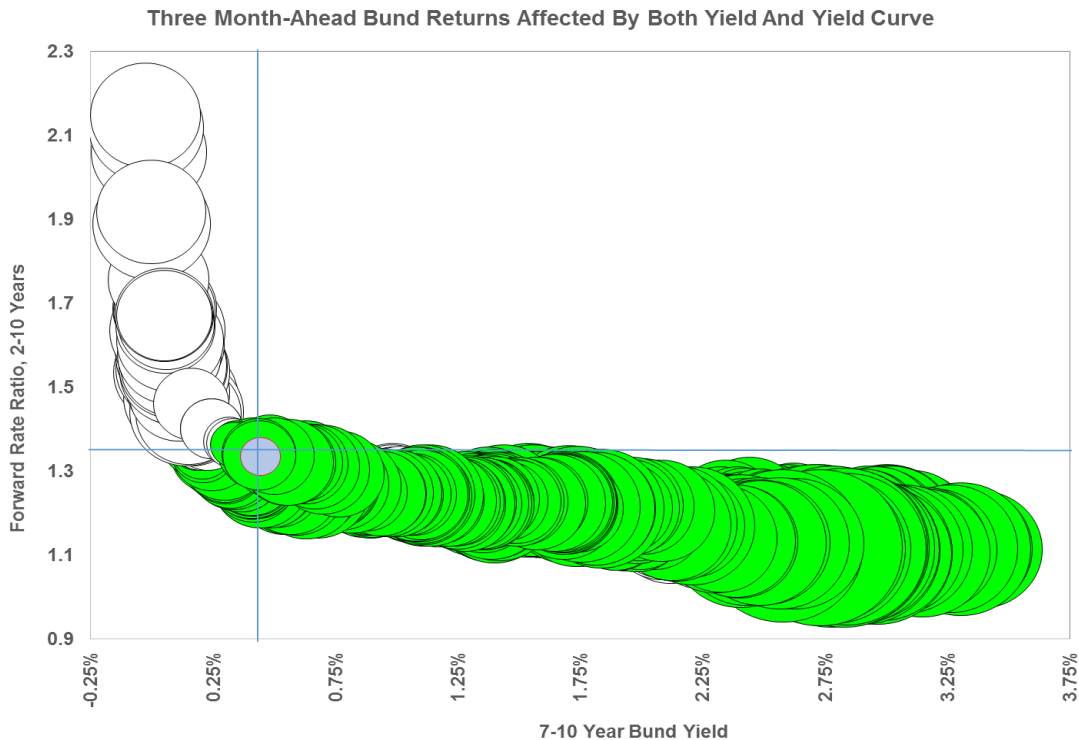


Large three month-ahead negative returns arrive primarily as a function of absolute yield and also as a function of a steep yield curve as measured by the forward rate ratio between two and ten years ($FRR_{2,10}$). This is the rate at which we can lock in borrowing for eight years starting two years from now divided by the ten-year rate itself. The steeper the yield curve, the more this ratio exceeds 1.00.

Let's map prospective returns as a function of 7-10 year yields and of daily changes in the USD:EUR carry return and the $FRR_{2,10}$. Positive prospective returns are depicted in green, negative prospective returns are depicted in white. The diameter of the bubble corresponds to the absolute magnitude of the return. The last datum used, from September 8, 2015, is highlighted and the current environment is marked with a bombsight.

In both cases, negative prospective returns dominate with a starting 7-10 year yield less than 30 basis points. They also dominate when the $FRR_{2,10}$ is greater than 1.30. Daily returns on the USD:EUR carry are not a factor.

The moral of the story is quite simple: Quantitative easing in the Eurozone has pushed Bund yields and the benchmark Eurozone yield curve to the point where Bunds are nothing more than return-free risk. If that is stimulative, I would like to know how.



Three Month-Ahead Bund Returns Affected By Yield, Not Euro

