WITWENMACHER – HOW LOW CAN 5-YEAR GERMAN BUNDS YIELDS GO?

Russell Clark's
Market Views

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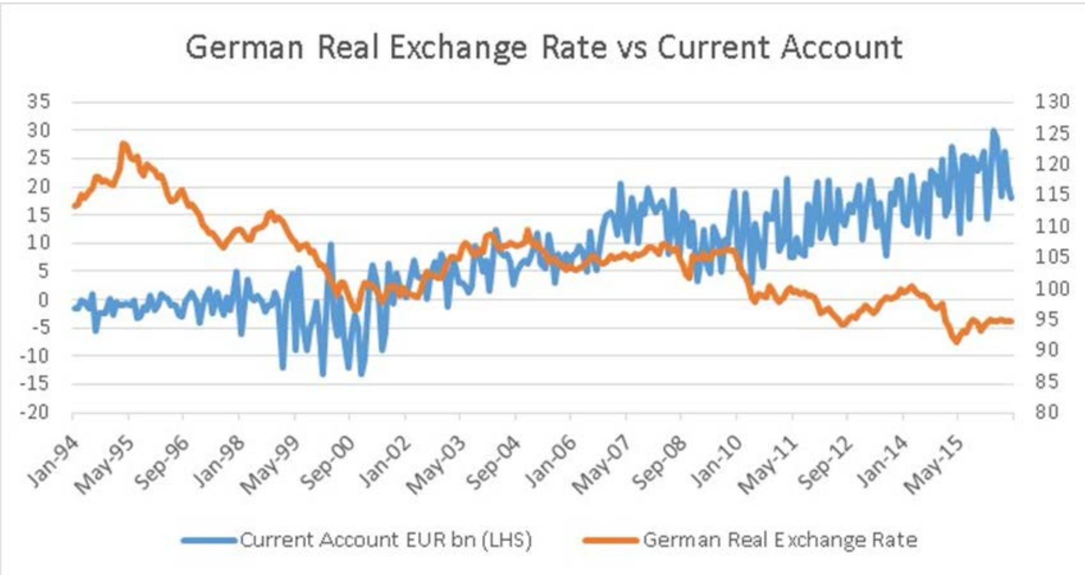
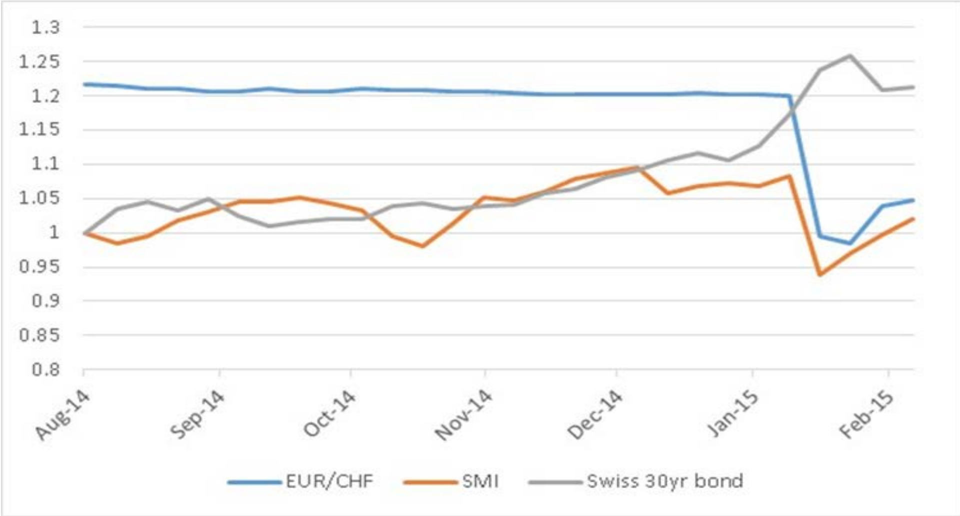
The European bond market is a very interesting market at the moment. Prior to 2007 all European sovereign bonds traded very similarly. Since 2011, European bonds have diverged despite the best efforts of the ECB. The received wisdom is the difference between bond yields reflect differing chances of default.

However, the Brexit vote and the rise of populist politicians in recent times have made a Eurozone breakup possible. This means that bonds will need to reflect the potential for currency gains or losses post breakup of the Euro.

So what would happen in a Eurozone breakup? Many of the outcomes are totally unpredictable, but one thing seems an absolute certainty to me, and that is that a new Deutsche Mark could appreciate substantially.



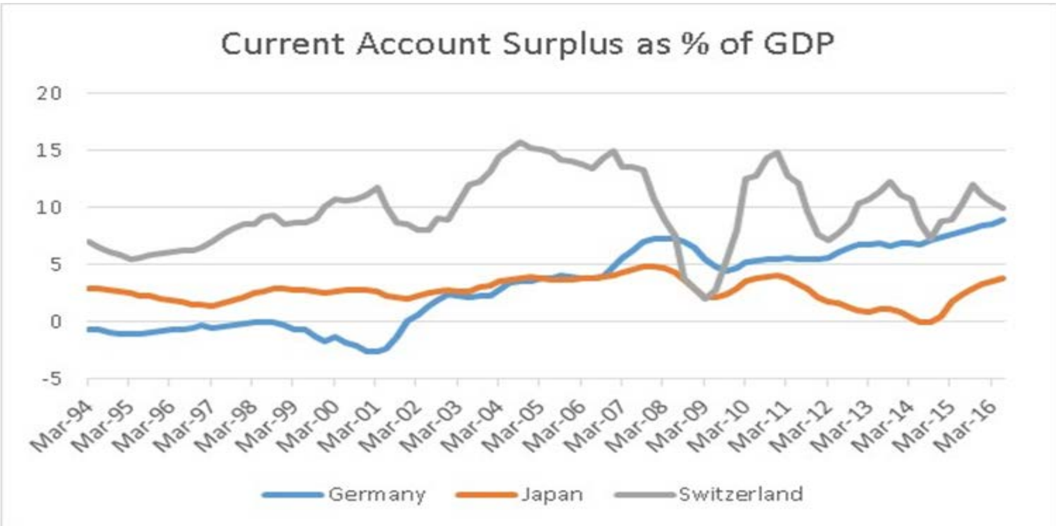
The surging German current account as the real exchange rate has fallen is a good reflection of this. Since the financial crisis, the Swiss Franc has appreciated as much as 40% against the Euro, so a new Deutsche Mark could rally 30% or more against any legacy Euro as well as the US dollar given the recent increase in the current account deficit there.

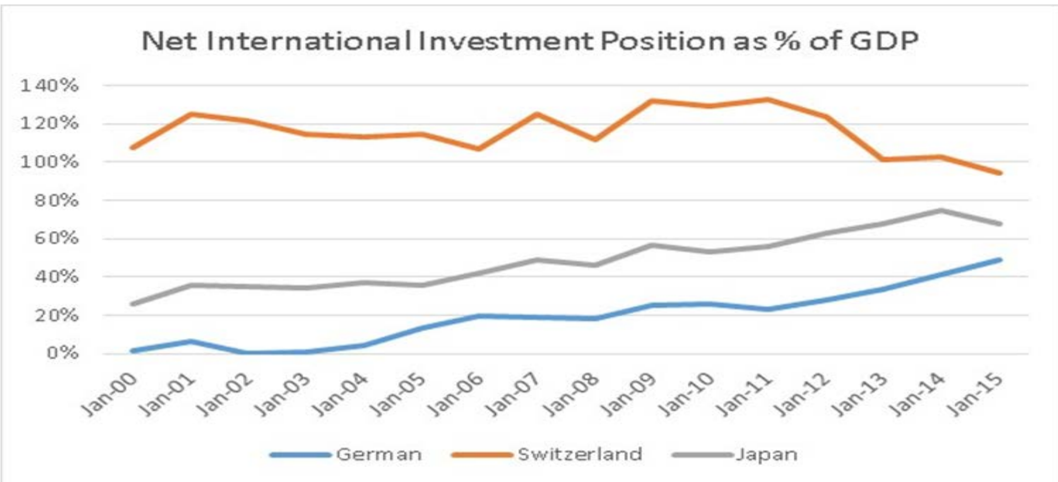


The question for investors, is how do you access this undervalued currency? The de-pegging of the Swiss franc from the Euro in 2015 offers some valuable lessons. Investors in Swiss assets would have noticed that when the Swiss franc left the Euro peg, this was bond bullish and stock market bearish.

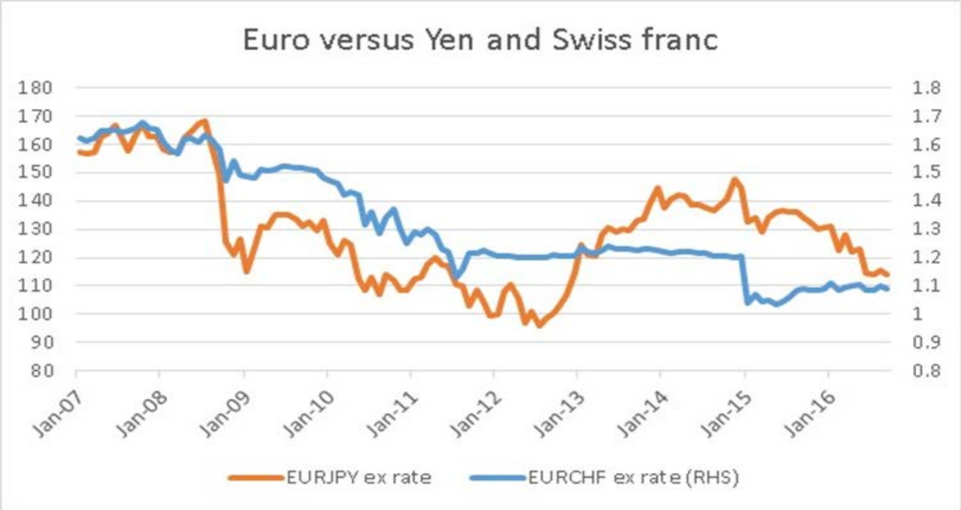
If Germany left the Euro, it would then have its own Central Bank, would interest rates rise substantially? I suspect not. I note that two countries with independent central banks and current account surpluses are Japan and Switzerland. Their five year bonds are currently yielding -0.2% and –0.9% respectively. Despite Germany being within the Eurozone, its 5 year bonds trade at -0.5%, indicating little or no potential currency appreciation being priced into the bunds.

Germany shares many characteristics with Japan and Switzerland. Large current account surpluses and a positive net international investment position.





It would seem reasonable to me that a freely traded Deutsche Mark would trade more in line with the Japanese Yen and Swiss Franc.



Since the financial crisis the Euro has traded very weakly versus the Swiss Franc and the Japanese Yen. Should the Deutsche Mark exit the Euro I would expect to trade back to levels seen on the cross rates in 2007 before concerns about the Euro surfaced. This implies a 40 to 50% increase.

As 5 year German bunds have yields close to Swiss and Japanese 5 year bonds, I assume the market is not pricing in any possibility that a new Deutsche Mark comes into existence in the next five years. If the market was 100% convinced that a new Deutsche Mark was going to come into existence, then over 5 years the bonds could trade to -10% yield. If we go for a 25% chance that a new Deutsche Mark comes into existence in the next 5 years, then 5 year Bund could price to a -2.5% yield. (50% currency appreciation X 25% chance of occurrence / 5 years). It looks like 5 year Bund yields could go much more negative.

Note: Witwenmacher is German for widowmaker.

INFORMATION

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