

# Rates: Ultra-low Bund yield rationalised by angst

The 10-year German yield at a mere c.20 basis points bears no reflection whatsoever on the Germany economy. So how can we make sense of this? Plain and simple, it is a combination of both macro and existential fear



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## Making sense of the German Bund

The 10-year German yield at a mere c.20bp bears no reflection whatsoever on the Germany economy. With nominal growth running in excess of 2.5%, such a low yield implies a negative real rate in excess of 2%, which under normal circumstances would imply significant macro angst. And while there has been a slowdown, it is nowhere near as sinister as that discount suggests. So how can we make sense of this?

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*The ultra-low 10yr German yield does not reflect the performance of the German economy*

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Plain and simple, the 20 basis point 10-year German yield is a measure of fear. And the closer we get to zero the more aggravated that fear becomes. That fear is a combination of two elements.

First, there is an element of macro fear - that the current slowdown could become more severe. But the more significant element is the fear underlying the European project, and not enough attention is being paid to this.

## Existential threats

The logic here is that long positions in Germany, even at just 20bp, come with a sizeable element of protection should the European project land on hard times. In other words, if it all fell apart, long positions in Germany offer the best possible outcome; a proxy Deutschmark. We are not anticipating a collapse, but it has to be said that such a scenario can be reverse-engineered from core market valuations, especially German ones.

Recent years have seen a whole series of existential threats come to the fore in the eurozone, starting with Greece and followed by numerous bailouts. Right now, we have a Brexit referendum awaiting execution, a populist government elected in Italy, and a rise in populism generally across Europe. This may not amount to anything too sinister, but then again we cannot be sure about that, especially given the number of improbabilities that have occurred in recent years.

As things stand, there is a spectrum of spreads above Germany that provide varying degrees of risk/return options. Italy is 265bp over Germany, which in itself is a remarkable spread. In part, it's driven by how low the German yield is. It's also circular, as the low German yield reflects a flight to safety, which is a necessary implication from political risks being taken elsewhere in the eurozone, with Italy being a good recent example.

## European elections

Against this backdrop, one of the key elements to watch over coming months will be the build-up to the European Elections in May. Not that the European elections are typically a significant event for bond markets, but this time they will act as a key barometer of where the European psyche is right now. A sizeable increase in the populist vote is expected, although ironically dented by Brexit, which will exclude UK separatists from having their say, as UK seats will be re-distributed or culled for now.

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*We think the EU elections coming in May will be an important measure of the sentiment in Europe*

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While there is a strong likelihood that the traditional pro-European parties will continue to dominate proceedings post the outcome of the elections, any significant gains made by parties of a disruptive ilk would add to the unease that is in play. We think the bond market discount is overly sinister here and that bund yields should be higher to reflect this (c.50+bp). At the same time, perhaps policymakers are not paying enough attention to the battle cries coming from the eurozone bond market.

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