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Carrying that free weight while on a safe passage into the eurozone

The current popular institutional barbell bond pairing trade sits between German bund bonds and Italian federal bonds and this combination allows the assertive market participant opportunity to shift risk between what is considered the anchor-weight of the eurozone bloc and the industrial, but far more volatile Italian market.

With the European election cycle injecting a dose of political uncertainty — in particular the German, French, Italian and Dutch elections — Australian global investors will be paying close attention to the credit spread between 10-year Italian government and German bund bonds, given:
• this acts as a barometer of risk within the European markets
• a high-risk political and economic environment historically leads to a wider spread as investors seek safety in the low-risk German bund
• inversely, during less risky market sessions, institutional investors seek yield in Italian bonds
• bunds offer a flight to quality option in the event of a eurozone collapse — political risks with upcoming elections. If the elections go as expected and there is eurozone stability, investors can sell the bund and keep the French/Italian bonds.

Focusing on the French elections in April, the rising popularity of right-wing candidate Marine Le Pen has created fears of the ever-growing possibility of “Frexit” and a broader EU unwind.

Although some are ruling out a Le Pen victory, to do so is dangerous, as evidenced by recent upsets in Brexit and Trump last year.

Moreover, the possibility of a joint-ticket campaign between left-wing candidates Benoit Hamon and Jean-Luc Melenchon has created fears within the investment community that such coalitions focus on social welfare rather than economic stability, would further distract sensitive financial markets.

As the graph highlights, this environment of uncertainty within the euro bloc’s second-largest economy has contributed to the Italian-German 10-year bond spread widening above 200 basis points, or 2 per cent.

As the election approaches, the popularity of these fringe candidates will play a substantial part in the decisions of global investors and allow barbell trade participants the opportunity to shift risk and return between German and Italian allocations.

However, savvy global investors will realise that assigning all of the uptick in the widening bond spread to the volatile political environment is an oversimplification.

Other reasons for a lack of investor confidence in Italian stability and thus high bond yields include:
• having the weakest growth and productivity trends in the region — at a mere 0.8 per cent, 0.5 per cent short of consensus estimates in calendar year 2016
• low labour participation rates coupled with rigid labour markets, which afford little room for improvement

• importantly, the inefficient treatment of non-performing loans — which accounts for about 18 per cent of Italy's total domestic bank loan book.

In contrast, the stringent approach of the German Bundesbank has seen these same metrics in the domestic German economy stay within prudent and conservative boundaries.

It must also be remembered that in times of market stress, investors favour liquidity over credit quality and when implementing binary — one or the other — trades such as the barbell trade, a degree of discretion is always called for given that sovereign bonds, in particular, move (or don't) for technical as well as fundamental reasons.

For Australian domestic investment communities who may find it a stretch to access eurozone bond markets, a comparative trade may be found in listed equity markets.

Representing the German stock bourse, ETFs such as the Deka DAX (ETFDAX: GR) and iShares Europe (IEU: AU) allow domestic Australian global investors to replicate the pro-German barbell position and respectively, iShares Currency Hedged MSCI Italy (HEWI: US) and iShares MSCI Italy Capped (EWI: US), riskier but higher-yielding Italian return profile.

Presenting trading and not necessarily longer-term investment opportunities, if such strategies were employed by Australians, it must always be remembered that these approaches are desirable to deliver better yields and most definitely do not have longevity.

Such approaches do allow Australian global and SMSF investors a fresh opportunity to mix their yield profiles away from traditional and overtraded domestic strategies here in Australia.

Remembering that our financial lives will continue to evolve throughout 2017, the most important barbell that Australian investors need to balance is that between sustainable returns and steady hands come what may across tumultuous geopolitical times.

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