German–American Interest Rate Differentials: The Bundesbank’s, ESG & A Federated Europe

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Often overlooked, the German–American economic nexus remains paramount and narrowing treasury and rate spreads witnessed in recent weeks signals important information, invaluable to the global investor discerning what is what during this challenging moment in time.

Cited:- A German Rough Patch 2016, 10 April 2019

In its simplest interpretation, the narrowing spreads communicate that either: (I) the US is losing its bid to weaken the overvalued Greenback, or (II) that the supranational European Commission’s, or EC’s, bold entrance into federalising Euro bloc debt via its newly announced euro-denominated bond issuance programs are more successful than the European Central Bank, or ECB, in acting as the prime price-setter for the European sovereign complex tête-à-tête the world, or, (III) neither scenario and therefore signalling the race towards the collective Zero Lower Bound, or ZLB, is nearing imminent breakdown.

Obviously proactively deciphering which of these three forces of change is materialising matters deeply to all fixed income and foreign exchange minded market participants: all set to signal deviations from established trends can carry enormous meaning when it comes to Transatlantic price signalling.

Cited:- Australian Dollar Impaired by The Greenback: The Threat Of A ‘Munchin Shock’ in April 2020, 4 April 2020

Cited:- Rising Bond Yields Have Many Consequences, 28 February 2018

German Bunds are universally seen as the ‘benchmark’ yield in the Euro area and historically macro modelling approaches are often built on this assumption.

The combination of the EC’s negative rates, forward guidance and QE has resulted in a sharp ‘bull-flattening’ of the German term structure, particularly since the middle of 2014 and thus it became significant that the European Union’s recovery fund announced in late July, in essence, establishes a Federated EU Finance Ministry, empowered to issue debt, raise taxes and spend the proceeds in its own right.

Lead by the EC, the recovery fund will issue up to €750bn in long-term bonds to finance Global Corona Crisis, or GCC, recovery programmes, distributing €390bn to member governments in the form of grants plus €360bn in direct loans.

The EC now vaults over existing European technocratic issuers: the European Stability Mechanism, or ESM, which has €90bn outstanding, the European Financial Stability Facility, or EFSF, representing a balance sheet of €73bn, and the European Investment Bank with €242bn.

The EC’s issuance will significantly deepen the pool of highly-rated and highly liquid euro-denominated assets, with the bloc currently rated AAA by two of the major agencies, and the increase in its issuance is unlikely to change that.

Caring more about Responsible Investing and Environmental, Social, Governance, or ESG than their colleagues on the respective US Federal Open Market Committee, or FOMC, the EC’s recovery fund even advocates a eurobloc tax on plastics, a border tax on carbon, a digital levy, an expanded emissions trading scheme and a financial transaction tax, inline with MiFID II.

Cited:- Scrutinising ESG: Bigger When The World Grinds To A Halt, 30 March 2020

Cited:- Environmental, Social, Governance (ESG): FOMO Not Fundamentals For Some, 21 March 2020

Cited:- When ESG Execution Misses The Point, 21 May 2019

Since 2015, German and Japanese yields have been driving other markets, including US Treasuries towards the ZLB and with starting yields now well below zero in real terms in June it became evident in nominal terms in Japan and Germany, the self-imposed ‘black zero policy’ – banning new debt within Germany – had to yield.

Cited:- H. Physio Toxic, M. German Economic Health To Gauge Asian Prospects, 24 October 2015

Watch:- Andrew Main & Stirling Larkin Discuss Germany, USA & Canada in 2015, 20 July 2015

Cited:- Play It Safe In Challenging Europe, 13 September 2014

Addressing the question surrounding the narrowing US–German spreads seen throughout August 2020, German bund yields are much closer to their lower limits and therefore have limited scope to fall, wherein US Treasuries have capacity to fall, resulting in the seismic spread compression seen following the July 2020 European Recovery Fund announcement.

Determining whether our collective attention needs to be directed towards the Bundesbank or Federal Reserve, the material remaining question is, has the market priced a ‘scarcity’ effect on Bunds resulting from QE that would act to depress yields, all else equal or has the net issuance of German securities placed downward pressure on 10-year yields?

German Bund yields vis-à-vis US Treasuries are traditionally priced: (i) the risk-free rate as measured by the overnight FOMA rate, allowing spreads to anchor the level of the yield curve; (ii) the one-month lagged 10-year US Treasury yield, as a control for the global business cycle, and possible ‘right-to-safety’ effects and (iii) a rolling monthly forecast of the German General Government budget balance (as a share of GDP) over the following year, as estimated by the EC.

As anyone who has handled macro financial time series would be aware, alternative specifications can sometimes generate quite different results.

One could, for example, argue that Bunds have been kept lower by concerns over developments in Russia, China and those surrounding BREXIT, although it is curious that such risks would not show up more prominently in other assets.

Cited:- European Markets Are Now Worth A Look, & Australian Investors Have An Advantage, 25 April 2018

All said, it very hard to generate – employing the prevailing set of macro expectations and calculations surrounding ‘scarcity effects’, ‘fair value’ estimates for 10-year German Bund and US Treasury yields – material markers denoting either a deterioration in the grand European project or the US Federal Reserve system.

The answers to why bellwether spreads are tightening and vacuity remain are likely to be found in the unnaturalness of the Zero Lower Bound, the epitome of evil and stupidity colliding.