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# Treasuries-Bund Trade Is About to Get Interesting

Option prices show downside risk to German bonds.

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**By Myron Scholes and Ash Alankar**

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The tide is turning.

In recent years, many investors have been burned by their conviction that the price of German bonds would fall relative to U.S. Treasuries of the same maturity, as the yield on the 10-year bund dipped for the first time into negative territory. But with the return of consistent growth and a reduction in near-term political risk in the euro zone, options prices indicate that interest rates are more likely to increase than decrease in Europe's largest economy. This is a significant departure from a number of months ago, when options market prices were neutral as to the direction of rates in Germany.

Options market signals indicate that yields on 10-year Treasuries are likely range bound and therefore the premium investors earn by holding U.S. bonds over their German counterparts is likely to fall as yields on the latter rise. Options function like insurance, with their prices providing efficient estimates of the market's assessment of the larger upside and downside risk of possible near-term outcomes. Most is gained by ignoring small possible changes -- the noise -- and by focusing on what is expected to be material.

Over a long history, the median spread between U.S. and German 10-year government debt averaged just less than 40 basis points, which is economically sensible given minimal risk differences between the two economies. With the recovery gaining traction in Germany and across the European Union, the likelihood increases that the spread will revert toward a more normal range in coming months. Since Dec. 27, the spread between German and U.S. debt has narrowed to 189 basis points from 235 basis points.



With economic data from the EU and its member nations consistently surprising to the upside in recent months -- and with options markets suggesting an enhanced possibility of continued strength -- the trend is more likely to continue as the European Central Bank moves closer to ending its ultra-accommodative monetary policy. The ECB's near-zero rate policy and almost \$2.6 trillion quantitative easing program -- which has boosted the central bank's balance sheet to \$4.7 trillion, more than that of the U.S. Federal Reserve -- are more consistent with a recession. Europe, however, is far from a recession.

The German economy is firing on all cylinders. Manufacturers saw the fastest growth in six years in May, while consumer spending, exports and investment contributed to an acceleration of quarter-on-quarter growth from January through March to 0.6 percent, from 0.4 percent in the fourth quarter of 2016. On May 22, The Bundesbank forecast that it expects the economy to grow "strongly" in the next few months.

By assigning an average level of expected upside to downside to European equities, the options market is more subdued in its expectations on the strength of this growth. But by also assigning limited expected downside to European equities, the options market is in agreement that growth is expected.

The rest of Europe is also showing improving growth. ECB President Mario Draghi on Thursday revised euro zone expectations upwards by 0.1 percentage point for each of the next three years, with gross domestic product now forecast to expand 1.9 percent in 2017, 1.8 percent next year and 1.7 percent in 2019. As a result, the ECB is expected to announce after its meeting on Sept. 7 that it will begin tapering bond purchases in January. Moreover, Bundesbank President Jens Weidmann -- tipped as a possible successor to Draghi when his term ends in October 2019 -- said May 22 that monetary policy will normalize sooner if wage growth pushes up inflation. German inflation has been ticking up since mid-

2016, and was 1.5 percent in May. Subdued supercore inflation, however, in the eurozone (which strips out volatile categories such as package holidays) means the ECB is more likely to normalize monetary conditions by ending its bond buying program before raising short-term rates.

While the end of QE should lift the yield on bonds of longer maturities, potentially steepening the yield curve, its impact on the euro will probably be more subdued compared with a rate hike, which would likely send the euro much higher. Although options market signals indicate that there is a greater possibility that the euro will appreciate than depreciate in coming months, the amount of expected upside is small. This may indicate that the options market expects the ECB's first move toward normalization to be ending QE. In all likelihood, a strong euro is a headwind that the ECB would rather not face, so the bank's apparent preference to end QE before hiking may be strategic.

The lift in long maturity European rates will likely narrow the relative carry U.S. bond holders are enjoying.

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