An Anatomy of a Sell Off – Taper Tantrum II

Bond land looks a little saner now that negative yields are disappearing from the Eurozone landscape. Those elevated prices never made any sense for real money investors, most of whom could not or would not buy bonds that would lock in a capital loss. That certainly is the hard reality for German insurance companies which collectively hold more German debt than any other institutions. Only hedge funds and trading desks that could leverage a carry trade at zero funding cost would bet that the carry would be worth the risk of capital loss. The 'greater fool' in this episode had to be the ECB whose belated and oversized asset purchase plans fomented this bond buying folly in the first place. Now bond prices have gone full circle back roughly to where they were prior to the buying frenzy in anticipation of the onset of the PSPP (ECB Euro-system public sector purchase program) in March.

In many respects, this bond selloff looks and feels a lot like the 'taper tantrum' of May 2013, except the ECB rather than the Federal Reserve lies at the centre of the volatility. Periods of monetary easing present an attractive environment for carry traders to arbitrage the spread between long rates and the low cost of funds (i.e., short rates). ZIRP (zero interest rate policies) make the carry doubly irresistible because funding is free and nearly unlimited. When the central bank adds QE in the form of outright bond purchases for its own account, you have the makings of a perfect storm: namely, free funding, unlimited liquidity and a huge pre-programmed buyer of last resort. Any spread differential is grist for the mill given enough leverage. The result is free money, at least until the central bank changes its mind, which they inevitably must because QE inherently are unsustainable. Hence the catalyst for the first taper tantrum was when Mr. Bernanke signalled that the Fed would wind down its asset purchases in the spring of 2013. This time, the signal was more subtle: you needed to know when the ECB would run out of bonds to buy, which also was inevitable because planned (and pre-announced) purchases exceeded new issuance of sovereign debt by a wide margin (by about 100 billion Euros in 2015 alone).

The only question was 'when'? A close look at the new issuance calendar provided clues. Euro zone governments planned a flurry of new issuance in May and June and then there was a long hiatus until September. The ECB belatedly announced it would 'frontload' its asset purchases during those spring months but to little avail. Yesterday the actual purchases of public sector bonds were announced and they fell far short of the planned 15-16 billion Euros per week, namely, only 10.65 billion Euros during the week ended June 12 and 12.9 billion during the prior week. Needless to say, an attentive carry trader can sense these diminished flows and knows the gig is up. There aren't enough bonds with yield available because real money accounts are not participating.

The rest was a fairly predictable example of contagious and knock-on selling. Once prices started to fall, retail clients rushed to sell their bond ETFs even in the seemingly unrelated high yield space. Few bonds were exempt because the reversion in prices began with the benchmark German bunds whose new issuance was exhausted first. Withdrawals from bond funds accelerated. Any bond with a bid was hit, regardless of credit quality. That sort of contagion has its limits, though. The best quality bonds tend to stabilize first even as credit spreads continue to widen. Institutional investors who sat out this roller coaster now will be more willing to engage again.

The Ultimate Endgame

On the ultimate endgame, your guess is as good as ours. Our insight so far has been that the ECB program was too big and too late to smoothly make a difference for the real economy. It didn't even facilitate deleveraging by the banks, nor does it finance any infrastructure spending or anything else that might raise the Euro zone's potential output. As soon as the hedge funds realised that the ECB might be forced to scale back, they all bailed out at once - hence Taper Tantrum II. Now we go through the phase in which credit spreads widen - partly because of Greece's insolvency and partly because of the endless uncertainty about whether the European experiment will work. Trade liberalisation and

EC citizenship were good ideas but monetary union was not so great, except on paper. Too much disparity and it has become worse. Greece will exit, if not this month then sometime soon. On that, the euro will selloff only to rise again when people realise the union is better off without Greece. Default, however, will cost German banks a lot of money and European banks in general will be dysfunctional for a long time. By comparison, the US and Chinese economies look good despite all their considerable issues.

All that sounds negative but 2016 will be a good year. Ignore the IMF projections for a slowdown; after all who listens to those forecasts anymore. The Federal Reserve will normalise and it won't matter much. Even seemingly moribund emerging markets will get a bit of a lift...but that is a long time from now and a lot else can go wrong we suppose.

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