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Redenomination Risk Emerges In German Bund Market

by Marcello Minenna on 28 March 2017

The last few months have seen a sizeable upward jump in government bond yields of the Eurozone countries: France, Italy, Spain have recorded increases ranging between 50 and 100 basis points.

With the notable exception of Germany, where rates continued their puzzling descent into negative territory. In late February German "Schatz" with a maturity of two years have even touched the unprecedented threshold of -1%. Demand is further on the rise: to invest in a Bund that will return €100 in two years one is willing to pay €101.6 to the German government, undergoing a net cost of €1.60.

The Bund market is therefore moving against the general upward trend in interest rates that can be mainly attributed to the recent revival of inflationary trends. In fact, European inflation rates have been going up from December 2016 due to rising energy and food costs, although the core inflation that determines the long-term expectations of market operators is still weak at around 0.6 %. In February 2017 the YoY inflation rate reached 2.2% in Germany and even 1.5% in Italy, where until October last year the economy was dealing with concrete deflation threats.

The other factor that is driving up yields is the market pricing of political risk. The European election cycle has started: the Dutch elections on March 15 kick-started what may well be a deep reshuffle of political leadership primarily in France, Germany and presumably Italy within 12 months. The uncertainty and the rise of populist movements are unattractive for markets that are demanding a rising premium on government bonds.

Therefore, behind the *Bund* behavior lie forces that are strong enough to overcome the effects of rising inflation and of political uncertainty. The conventional explanation points – in part correctly – to the *safe haven* role of *Bunds* in global markets and to the strong demand for German assets as high quality collateral for interbank lending. But both factors have been at work for years and cannot account for the recent extreme price moves. Something else is at work here: the cumbersome weight of ECB *Quantitative Easing*.

Indeed, the ECB is continuing to put pressure on the *Bund* secondary market by buying bonds at a monthly pace of €17-18 billion. The ECB cannot slow down the pace below these thresholds, since it would violate the "*capital key*" rule, according to which German government bonds should be the most purchased asset. At the end of February 2017 almost €350bn of *Bunds* had been purchased and the remaining eligible stocks rapidly dwindling.

The problem of *Bund* shortage was already known in December 2016, when, in order to allow the extension of QE to end-2017, the ECB was forced to eliminate some buying restrictions. Until then, the ECB had been limiting its purchases to securities with a maturity of over 2 years and an implicit yield higher than -0.4%, the rate at which Eurozone banks pay for deposits they are obliged to hold at the central bank. This rule made sense in the perspective of preventing the ECB from acquiring German bonds at a loss. Then, the negative return paid by the ECB was offset by gains from deposit accounts.

Until 2016 the deposit rate rule effectively put a cap on the rise in price of short-dated bonds, thus artificially flattening the German government's interest term structure around similar values along all maturities.

The explanation for this flattening pattern is intuitive. If prices rise, yields fall. However, if the *Bund* implied yield falls below the deposit rate, the bond becomes ineligible for QE. For banks, therefore, it has been better to trade around the threshold, in the perspective of re-selling the *Bund* to the ECB at a profit in the event of a deposit rate cut, especially if that measure were to be announced widely in advance. Banks made profits from this sort of arbitrage strategy when the ECB cut the deposit rate to -0.3% in December 2015 and to -0.4% in March 2016. These gains have helped banks to partially compensate for the impact of low interest rates on their overall profitability.

In September 2016 something changed: Draghi officially suggested to the market not to expect further interest rate cuts. Market operators dropped their arbitrage trades and gradually recommenced quoting *Bund* prices with fewer distortions. In January, the ECB lifted the last barrier on deposit rate, restoring a more credible price discovery.

This was the moment when *redenomination risk*, i.e. the risk that a euro asset will be denominated in a different currency after exit from the monetary union clearly surfaced also on Bund markets. With the French elections rapidly approaching and Mme Le Pen promising a swift French exit from monetary union, pricing this risk makes sense.

In the case of the Bund, however, there is a hidden paradox. If the *Bund* were to be paid back in the new *Deutsche Mark* the investor would receive his capital in a revalued currency against the Euro. Market estimates a Mark's likely revaluation at between 10% and 20%, leaving the potential of a gain up to 20%. It has been this *redenomination opportunity* embedded in the *Bund* price that has driven down the yields to the extreme levels (up to -0.97%) recently experienced.

With prices of short-term securities that better reflect the risks involved, it is possible to calculate the implied probability that the market is assigning to the event of a return to the *Mark* within 2 years: estimates range from 3% to 7% depending on the revaluation scenario. This range is fairly low but consistent with numbers calculated in a more conventional way from the prices of Italian bonds on the same maturity (6% for a return to the Lira). Moreover, they are steadily increasing.

Converging market expectations are a clear signal of turbulent times ahead for the Euro.